



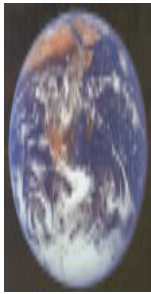
# Credit Risk Management Seminar for Commercial Bankers in Ghana

Presented by:



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# Overview

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## **Introduction**

Risk and Banking  
The Nature of Risk Management ...  
Risk Management is  
Why is Risk Management Relevant Now?  
Historical Approach to Risk Management  
Evolving Trends  
Risk Management versus Risk Control  
Objective versus Intuitive Approach  
Interactive Management Structures and Processes  
Benefits of an Integrated Risk Management Framework  
Risk Management Culture

## **Risk Management**

What is Risk?  
Risk Management System  
Bank Earnings Analysis and Model  
Major Risk Areas  
Risk Management System  
Responsibility and Duties  
Policies  
Good Risk Policies  
A Check List  
How Policies and Components Are Related  
Measurement is Essential  
Monitoring and Control

## **Credit Risk Management**

Credit Policies  
Administration of Loan Policy Planning and Credit Policy  
Key Success Factors  
Credit Culture  
Credit Management System  
Credit Management Framework  
Overview- The Key To Sound Credit Management

Framework for Credit Analysis  
Five "C'S" of Credit  
Credit Initiation & Analysis Process  
Spreadsheet  
Classes of Ratios  
Foundations of Creditworthiness  
Industry Dynamics  
Financial Condition  
Management Quality  
Collateral Realization  
Example of Risk Acceptance Guidelines  
Contents of a Business Plan  
Cash Flow Choices  
Cash Flow Analysis

## **Credit Approval, Loan Structure, Loan Administration**

Credit Decision Process  
The Steps in the Credit Methodology Decision Tree  
Preparing the Credit Approval Package  
Credit Approval Steps  
Key Supporting Documents  
Credit Approval  
Seasonal Loans  
Bridge Loans  
Permanent Working Capital  
Term Loans  
Guarantors and Co-signers  
Guarantee Spectrum  
Loan Agreements  
Typical Loan Agreement Components  
Loan Pricing Methodology  
Risk Adjustment  
Pricing  
Loan Review vs. Loan Monitoring  
Objective of Loan Review  
How Loan Review Performs its Function

FIVE Specific Issues When Examining Individual Credits  
Portfolio Trends Track  
Contents of the Loan Review Report  
Disbursement Control  
Credit Approval Memo Sample  
Credit Administration

## **Portfolio Management, Loan Monitoring, Loan Classification**

### **Portfolio Management**

### **Process for Establishing and Implementing Portfolio Exposure Limits**

### **Portfolio Limits**

### **Credit Monitoring**

### **Loan Monitoring**

### **Other monitoring activities**

### **Quarterly Customer Calls & Site Visits**

### **Monitoring Data Collection**

### **Required Actions for Non-Payment**

### **Customer Classification Plan**

### **Standards for Classifying Loans**

### **Classifications Definitions**

### **Quarterly Review of Classifications**

### **Remedial Action for High Risk or Worse**

### **Examples of**

### **Warning Signs and Data Gathering**

## **Problem Loans**

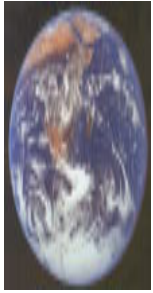
### **Problem Loan Administration**

### **Avoiding Problem Loans**

### **Critical Occurrences**

### **Calculating a Debt Service Deficiency**

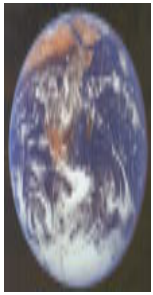
### **Analyzing the Problem Loan**



# Risk and Banking

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- A financial institution is confronted with many types of risk.
- Management's attitude toward risk and its ability to understand and manage risks determine the long-term profitability for the institution.



# The Nature of Risk Management ...

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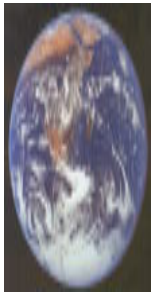
in banks is changing fundamentally. Until recently, it has been an exercise in damage limitation. Now it is becoming an important weapon in the competitive struggle between financial institutions.

Those who can manage and control their risks best will be the most profitable, lowest priced producers.

Those who misjudge or misprice will be out on their ear.

*-The Risk Game*

*The Economist, Survey of  
International Banking (1996)*



# Risk Management is:

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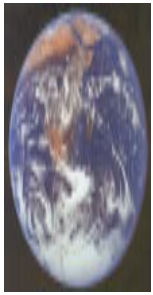
- The deliberate acceptance of risk for profit. It involves making informed decisions regarding the trade-offs between risk and reward, and using various financial and other tools to maximize risk-adjusted returns within pre-established limits

## designed to:

- Prevent Loss
- Insure Loss
- Control Loss
- Price Risk Appropriately

## includes:

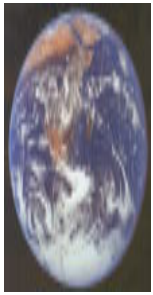
- Comprehensive Risk Policy
- Monitoring/Reporting Procedures
- Enforcement



# Why is Risk Management Relevant Now?

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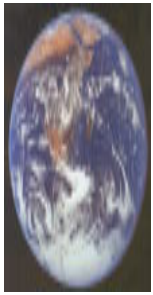
- A changing market
- Customer preferences, behavior and sophistication
- Complexity and velocity of international financial markets
- Increase in transactional volumes
- Competition of non-bank financial services
- A changing industry
- Banks' share of traditional businesses is shrinking
- Expansion into new businesses and geographical markets
- Traditional products are changing in nature or delivery
- Reorganization of industry
- A changing world
- Emergence of developing markets: Eastern Europe, China
- European alliance
- Technological advances



# Historical Approach to Risk Management

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- Focused on a few traditional risks
- Risk avoidance is prevailing attitude
- Compartmentalized structures
- Subjective views
- Inconsistent response and application of resources
- Not well connected to business activities and goals
- No overall risk profile to support executive decisions

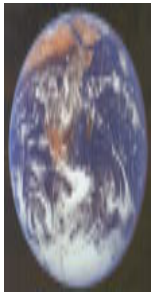


# Evolving Trends

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- Awareness of expanded risk categories
- Risk for reward
- Quantity of risk and quality of risk management
- Objective vs. intuitive approach
- Measurement and management on portfolio level
- Interactive management structures and processes
- Link to strategic planning/business goals

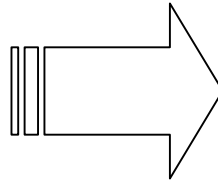




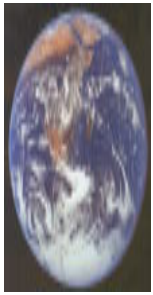
# Risk Management versus Risk Control

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***Risk Control***  
**Decrease**  
**Avoid**  
**Insure Limit**



***Risk Management***  
**Sell/Share**  
**Hedge/Transfer**  
**Absorb/reserve for**  
**Price for Limit**



# Objective versus Intuitive Approach

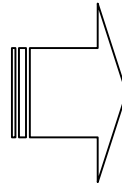
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## ***Intuitive***

People dependent

Single risk process

Intuitive Understanding



## ***Objective***

Process dependent

Independently validated

Data informed

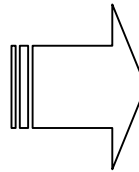


# Interactive Management Structures and Processes

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## *Compartmentalized*

Credit  
ALM  
Legal



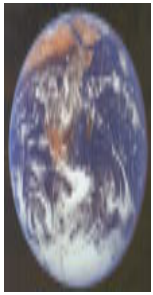
## *Interactive*

Risk Committees

## *Oversight by*

Chief Credit Officer  
Chief Financial Officer

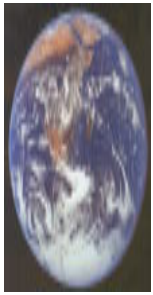
Chief Risk Officer



# Benefits of an Integrated Risk Management Framework

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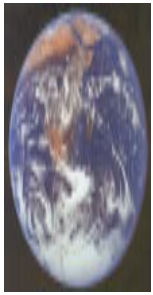
- Promotes and strengthens a consistent risk culture
- A clear and consistent position on risk enhances market image
- Supports the efficient use of financial and human resources for maximum risk-adjusted returns
- Facilitates the dissemination of multi-dimensional risk knowledge and expertise to where it makes a difference
- Provides corporate level overview of risks and risk trends for strategic and business planning
- Enables performance evaluation on a risk-adjusted basis



# Risk Management Culture

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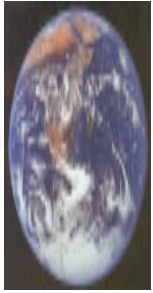
- Common language
- Consistent measurement and methodologies
- Integrated processes
- Clear roles and responsibilities
- Excellent training and communications
- Technology supported-MIS a key driver
- Not bureaucratic—enabling, not controlling



# What is Risk?

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*Risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital and/or earnings*

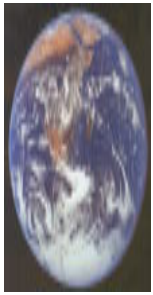


# Risk Management System

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## Building Blocks

- Risk Identification
- Risk Measurement
- Risk Management
- Risk Monitoring/Controlling

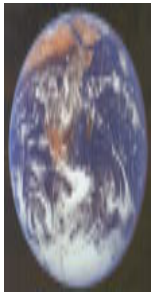


# Bank Earnings Analysis and Model

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- Banks make money by assuming risk
- Banks lose money by not managing risk or by not getting paid for the risk assumed

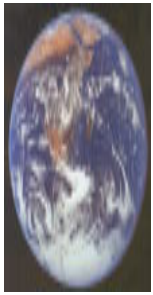




# Major Risk Areas

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- Operational Risk
- Liquidity Risk
- Price Risk
- Foreign Exchange Risk
- Interest Rate Risk
- Credit Risk



# Risk Management System

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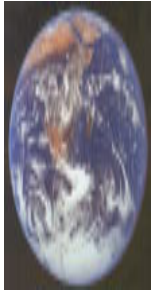
- Who is ultimately responsible for risk management?
- The Board of Directors has the fiduciary responsibility to manage an institution in a safe and sound manner



# Responsibility and Duties

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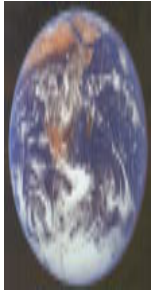
- Define
  - a risk management process
- Assign
  - responsibility and authority
- Review
  - reports
- Understand
  - amount and types of risk



# Oscar Wilde said...

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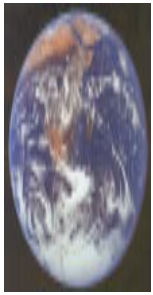
*“Experience is the name we give to our past mistakes”*



# Policies

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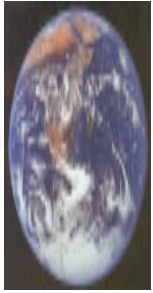
*are a means of passing experiences to a new generation of management*



# Good Risk Policies

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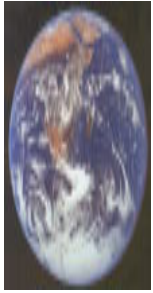
- Assign responsibilities and duties
- Define risk measures
- Set risk limits
- Specify how to handle exceptions to limits
- Set times for review and revision
- Set how and when the process should be audited
- Receive Board of Directors' approval



# Each section should contain

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- What
- Why
- Who
- Where
- How
- How much
- When

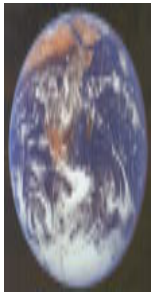


# A Check List

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- WHAT
  - Overall statement of goals and objectives
- WHY
  - Definition of a risk and its consequences
- WHO or WHERE
  - Assignment of responsibilities within the organizational structure

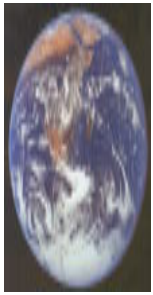




# A Check List (continued)

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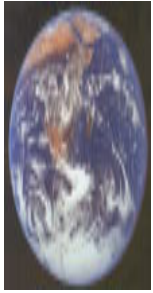
- HOW
  - Description of how the assignees are to function as a team
  - What risk management tools can be used
- HOW MUCH
  - Description of measures and acceptable limits
- WHEN
  - Specification of content and frequency of reporting



# How Policies and Components Are Related

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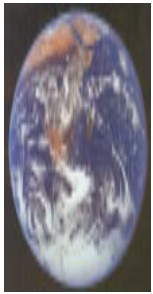
- Understanding risks
  - What, Why
- Collecting data on risk
  - Who, Where, How
- Measuring risk
  - Who, How much
- Managing risk
  - Who, How, When



# Measurement is Essential

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Saying “don’t take too much risk” is like saying “don’t swim too far from shore”



# Monitoring and Control

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## **Preventive Controls**

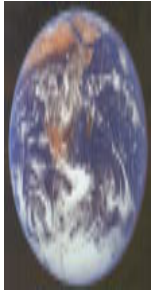
- Internal controls designed to prevent errors, irregularities, fraud or misstatements of financial statements resulting from an event

## **Detective Controls**

- Controls designed to detect errors, irregularities, fraud, or misstatements of financial statements after the event for the purpose of correcting the condition

## **Corrective Controls**

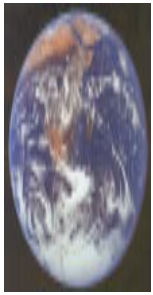
- Controls to resolve the error, irregularity fraud or misstatement of financial statement resulting from an event



# Credit Risk Management

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- Credit Culture and Policy
- Credit Initiation and Analysis
- Credit Risk Measurement
- Credit Monitoring/Loan Administration
- Credit Workout

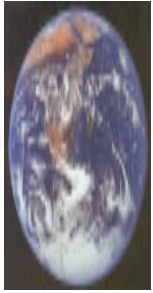


# Credit Policies

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**Approval and Enforcement of Credit Policies are a primary responsibility of directors and senior management to ensure bank objectives are met...**

- Credit Policies not only set the framework but also reinforce credit culture
- Conservative credit policies should set a conservative culture
- Conservative credit policies will reinforce a conservative culture if **enforced**
- Credit Policies should be specific and unambiguous (see facing page)

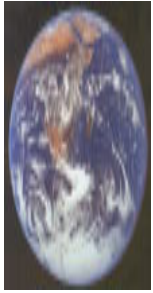


# Credit Policies (Cont.)

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Credit Policies Should Be:

- Accepted and understood by all credit personnel
- Enforced by line management
- Should be clear, concise, and relevant

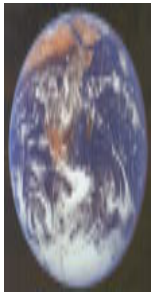


# Credit Policies (Cont.)

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- Credit Policies are usually supported by Credit Procedures
- Communicating change in credit policy to staff and customs gives a clear and consistent signal

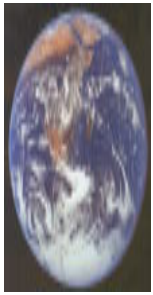




# Administration of Loan Policy Planning and Credit Policy

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- Purpose of Planning
- Benefits of Planning
- Basic Bank Credit Cultures
- Written Loan Policy
- Objective of Loan Policy

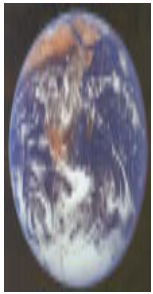


# Key Success Factors

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**The combination of a strong credit process and credit culture can control and minimize these key causes of credit problems**

Credit Process	Credit Culture
<ul style="list-style-type: none"><li>• Incomplete credit information</li><li>• Poor risk selection</li><li>• Technical incompetence</li><li>• Overlending</li></ul>	<ul style="list-style-type: none"><li>• Self dealing</li><li>• Anxiety for income</li><li>• Compromise of credit principles</li><li>• Complacency/poor supervision</li><li>• Competition</li><li>• Failure to enforce agreements</li></ul>

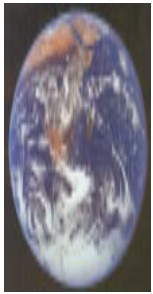


# Credit Culture

## CREDIT CULTURE AT ITS ESSENCE IS THE COMMITMENT TO FOLLOW THROUGH IN ADHERING TO SOUND CREDIT PRINCIPLES

The commitment must start from the top:

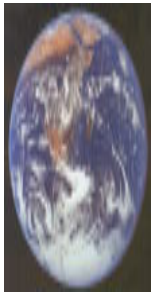
- Governance, i.e., owners, board members Senior management
- If the board and top management have the commitment to a sound credit culture, they will influence credit personnel to exercise prudent judgment
- Prudent credit culture is critical to achieving solid credit quality because no matter how good the process, judgment is always involved in making credit decisions
- Lending is an art, not a science
- The judgments required will be heavily influenced by the culture
- Prudent culture: Conservative, patient, thorough, diligent, full disclosure
- Weak culture: Optimistic, misleading, open to influence, excessive risk taking
- **EACH GROUP OF CREDIT PERSONNEL HAS A DIFFERENT ROLE IN ACHIEVING A SOLID CREDIT CULTURE**



# Credit Culture (Cont.)

**PERSONNEL INVOLVED IN THE PORTFOLIO MANAGEMENT FUNCTION SHOULD DRIVE THE CREDIT CULTURE...**

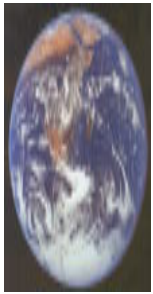
PORTFOLIO MANAGEMENT FUNCTION	
Participants	Role
Owners	<ul style="list-style-type: none"><li>◆ Active oversight</li><li>◆ Appointment of high integrity Board</li><li>◆ Avoidance of self dealing</li></ul>
Board Member	<ul style="list-style-type: none"><li>◆ Active oversight</li><li>◆ No self dealing, high integrity</li><li>◆ Technically capable</li></ul>
Credit Policy committee	<ul style="list-style-type: none"><li>◆ Set credit policy</li><li>◆ Determine risk parameters</li><li>◆ Actively monitor credit quality and upgrade as situation requires</li></ul>



# Credit Culture (Cont.)

**RELATIONSHIP MANAGEMENT PARTICIPANTS ARE ON THE FRONT LINE AND MUST REINFORCE THE CULTURE THROUGH THEIR DAILY INTERACTIONS...**

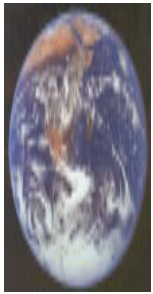
PARTICIPANTS	ROLE
<ul style="list-style-type: none"><li>◆ Relationship Managers<ul style="list-style-type: none"><li>◇ Initiation/Monitoring</li><li>◇ Workout</li></ul></li></ul>	<ul style="list-style-type: none"><li>◆ Front line</li><li>◆ Ensure standards are met<ul style="list-style-type: none"><li>◇ Attention to detail</li><li>◇ Thorough</li><li>◇ Diligent</li></ul></li><li>◆ Forceful</li></ul>
<ul style="list-style-type: none"><li>◆ Credit Division Managers<ul style="list-style-type: none"><li>◇ Credit approval</li><li>◇ Policy creation</li></ul></li></ul>	<ul style="list-style-type: none"><li>◆ Sound judgment</li><li>◆ Adherence to and enforcement of sound credit policy</li></ul>
<ul style="list-style-type: none"><li>◆ Credit administration Officers<ul style="list-style-type: none"><li>◇ Files</li><li>◇ MIS</li><li>◇ Policy adherence</li></ul></li></ul>	<ul style="list-style-type: none"><li>◆ Attention to detail</li><li>◆ Non-compromising of credit policy</li><li>◆ Monitor quality</li></ul>



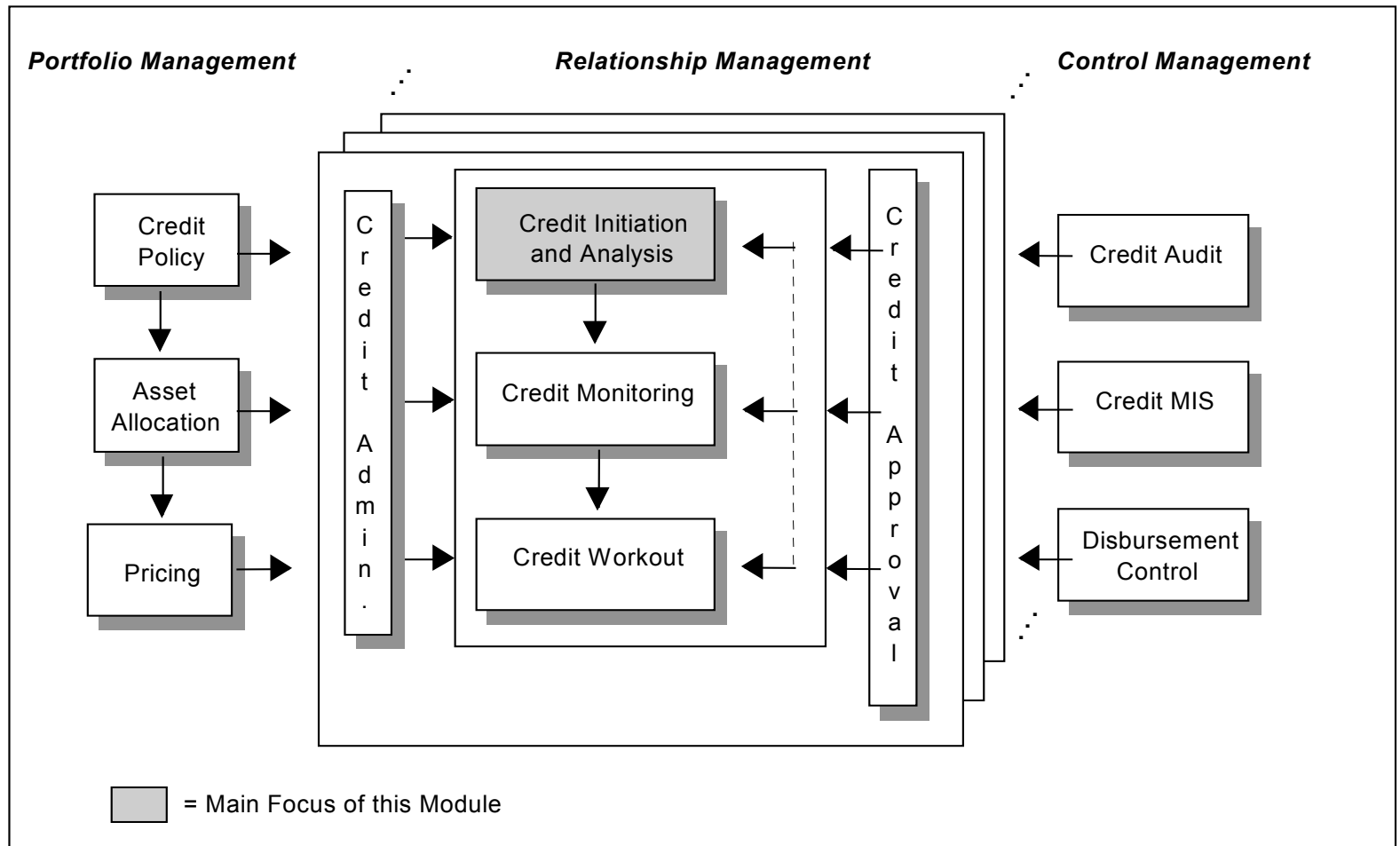
# Credit Culture (Cont.)

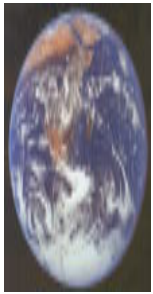
**THE KEY ROLE OF CREDIT CONTROL PARTICIPANTS IS TO MAINTAIN THE OVERALL INTEGRITY OF THE PROCESS AND CULTURE...**

PARTICIPANTS	ROLE
◆ Credit audit	<ul style="list-style-type: none"><li>◆ Review loan quality</li><li>◆ Ensure policy adherence</li><li>◆ Maintain independence</li><li>◆ Remain unbiased</li></ul>
<ul style="list-style-type: none"><li>◆ Disbursement control<ul style="list-style-type: none"><li>◇ Branch personnel</li><li>◇ Control clerks</li></ul></li></ul>	<ul style="list-style-type: none"><li>◆ Control available funds</li><li>◆ Review documentation</li><li>◆ Maintain independence</li><li>◆ Maintain high attention to detail</li></ul>
◆ Credit MIS	<ul style="list-style-type: none"><li>◆ Diligent</li><li>◆ Attention to detail</li><li>◆ Creative</li></ul>



# Credit Management System





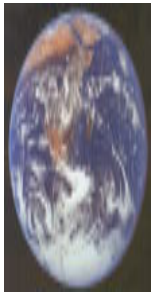
# Credit Management Framework

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**THE KEY TO SOUND CREDIT MANAGEMENT LIES IN EVALUATING AND CONTROLLING INDIVIDUAL CREDIT RELATIONSHIPS AND THE PORTFOLIO AS A WHOLE (REFER TO FACING PAGE)...**

- Portfolio Management should operate at a strategic level and determine the kinds of risks the bank will accept and how much will be accepted
  - Credit policy should set the overall rules and risk parameters a bank operates within
  - Asset allocation guidelines limit type and amount of risk that a bank will take by industry/sector or other predetermined controls
- Example: Commercial Real Estate concentration not managed at a strategic level at US banks in 1980s
- Pricing guidelines determine what a bank must charge to remain profitable



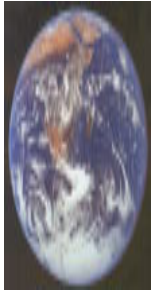


# Credit Management Framework (Cont.)

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**THE KEY TO SOUND CREDIT MANAGEMENT LIES IN EVALUATING AND CONTROLLING INDIVIDUAL CREDIT RELATIONSHIPS AND THE PORTFOLIO AS A WHOLE (REFER TO FACING PAGE)...**

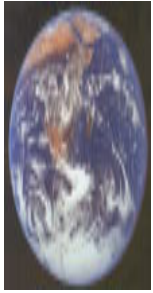
- Credit Analysis, Monitoring and Credit Workout should be Relationship Management processes focused on measuring and containing individual credit risks within strategic guidelines
  - Credit Analysis focuses on evaluating the creditworthiness of individual borrowers and structuring individual credits
  - Credit Monitoring focuses on ensuring that creditworthiness is maintained
- Credit Workout focuses on regaining creditworthiness once it is lost



# Overview- The Key To Sound Credit Management

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- Credit Approval and Administration should be the line control process embedded in the relationship processes
  - Analysis, Monitoring and Workout Management all involve decisions which entail risk and require line control
- The Approval Chain and Authorities should be common to each relationship process

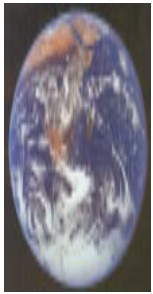


# Overview- The Key To Sound Credit Management (Cont.)

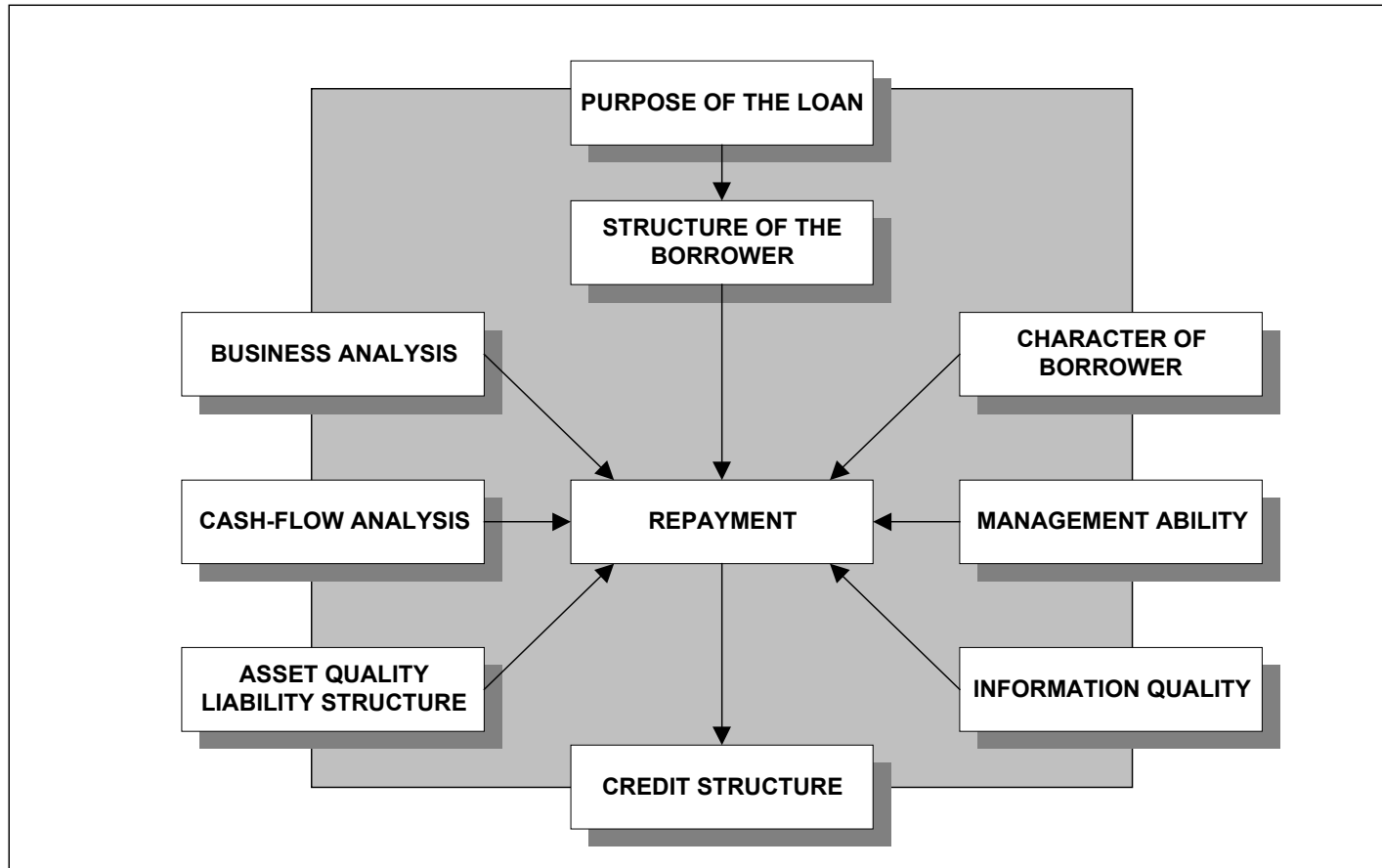
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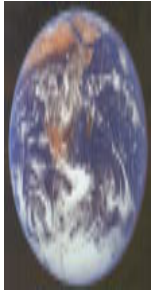
- Control Management should be an independent management control process that reviews the individual credit decision, portfolio composition and staffing of each business unit
- Credit Audit should be a qualified, independent review of credit decisions
- Credit MIS should provide both Relationship Managers and Control Managers with proper information to monitor credit quality
- Disbursement control should ensure that money is not availed until all approval and documentation requirements are met

WE WILL NOW BRIEFLY REVIEW EACH COMPONENT OF THE FRAMEWORK



# Framework for Credit Analysis

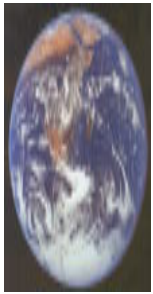




# Five “C’S”

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- CHARACTER
- CAPACITY
- CAPITAL
- CONDITIONS
- COLLATERAL



# Five C's (Cont.)

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## **Character**

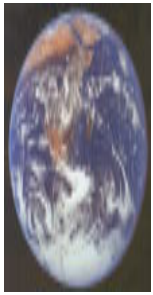
- Does the borrower demonstrate a commitment to honor his transactions and keep his promises even under adverse circumstances?

## **Capacity**

- Does the business demonstrate the capacity to apply the loan funds?
- Does management have a business plan? Are plant and equipment sufficient? Are marketing and product delivery well developed?

## **Conditions**

- What are the economic and market conditions that could impair the company's ability to service the debt and repay the loan?
- Does the company recognize these risks and have plans to mitigate them?



# Five C's (Cont.)

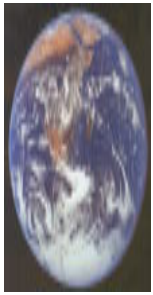
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## Capital

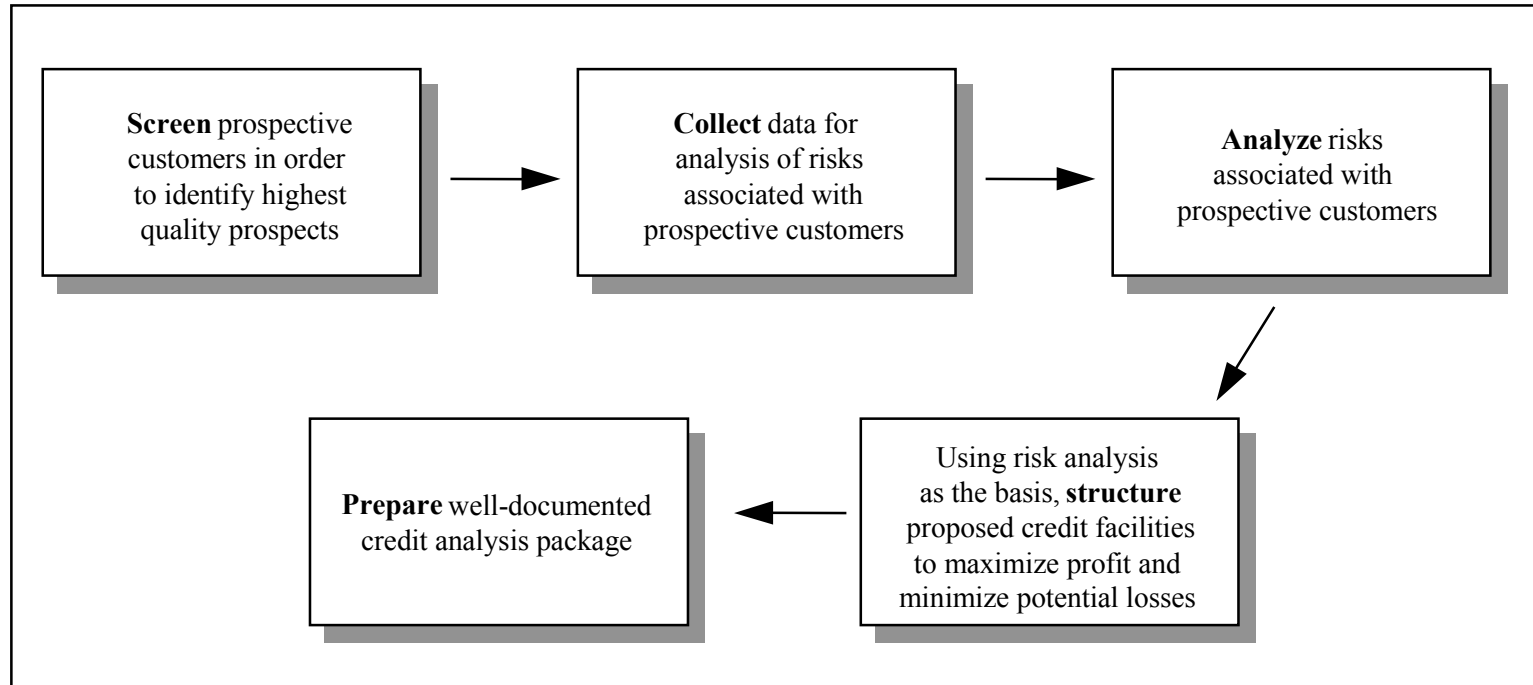
- Does the company have sufficient net worth to absorb normal business risk?

## Collateral

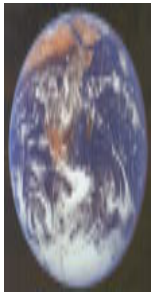
- Is the collateral sufficient as a secondary source of repayment? If the collateral must be liquidated, is the realizable value enough to repay principal, outstanding interest, and cover the bank's administrative costs of liquidation?



# Credit Initiation & Analysis Process





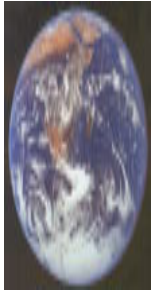


# Initiation & Analysis

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**CREDIT INITIATION & ANALYSIS SHOULD ENSURE THAT LOANS ARE WITHIN POLICY GUIDELINES AND MEET CREDIT STANDARDS...**

- Initiation & Analysis Process should follow a typical diagnostic process flow, beginning with data collection and moving to actions (refer to facing page)
- Analysis of risks should focus on the four foundations of creditworthiness



# Initiation & Analysis (Cont.)

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## Industry

- focuses on the industry dynamics and company position within the industry. Weakness in the industry foundation can significantly affect repayment ability
  - Commodity industry, i.e. cocoa, is important

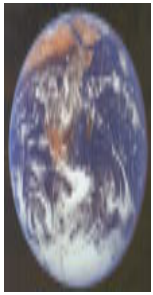


# Initiation & Analysis (Cont.)

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## Financial Condition

- determines the borrower's ability to generate sufficient cash to repay or ability to draw on existing resources, e.g., capital or assets, to repay bank borrowings. The three specific measurement criteria are
  - profitability,
  - liquidity and
  - leverage



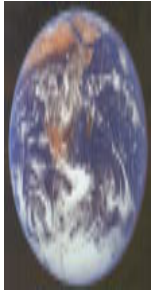
# Initiation & Analysis (Cont.)

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**CREDIT INITIATION & ANALYSIS SHOULD ENSURE THAT LOANS ARE WITHIN POLICY GUIDELINES AND MEET CREDIT STANDARDS...**

## Management Quality

- determines the competence, integrity and alliances of the key individuals running the company.  
Weakness here can affect not only repayment ability but security realization

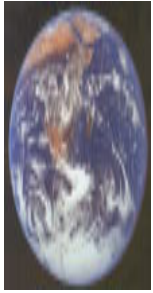


# Initiation & Analysis (Cont.)

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## Security Realization

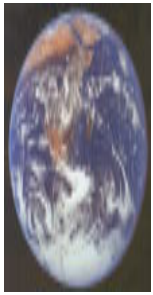
- determines the level of the bank's control over collateral and the likely liquidation value, factoring in time, i.e., net present value. Weakness in security realization threatens second source of repayment



# Credit Initiation & Analysis Should Ensure Loans

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- Based on the analysis of these four foundations, the credit should be “structured” to contain risks and meet return requirements
- This structure should be approved based on the Approval Policy and Credit Authorities established by the Credit Policy Committee
- Finally, facilities should be booked and dispersed

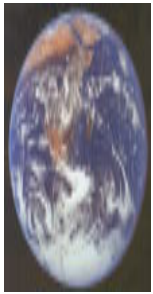


# Spreadsheet

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## **Spreadsheets enable the bank to:**

- Establish common definitions of financial ratios and common size comparison of income statements, balance sheets, and cash flow items.
- Facilitate the calculation of key ratios and cash flow analysis.
- Identify and highlight critical information and ratios for analysis.

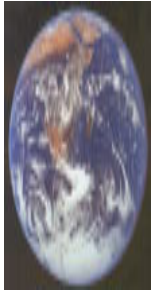


# Classes of Ratios

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- Liquidity
- Efficiency
- Profitability
- Valuation

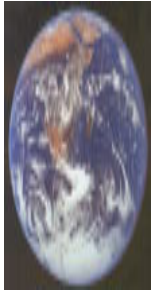




# Liquidity Ratios

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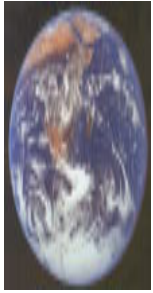
- Current
- Quick



# Efficiency Ratios

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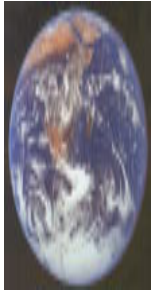
- Receivables turnover
- Inventory turnover
- Payables turnover
- Fixed asset turnover
- Debt/equity



# Profitability Ratios

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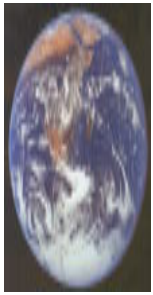
- Interest coverage
- Fixed charge coverage
- Net profit margin
- ROA
- ROE



# Valuation Ratios

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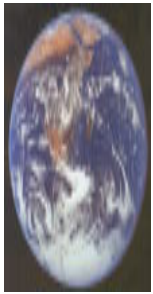
- Price/Earnings
- Market/Book



# Foundations of Creditworthiness

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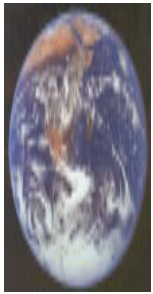
- Industry Dynamics
- Financial Condition
- Management Quality
- Collateral Realization



# Industry Dynamics

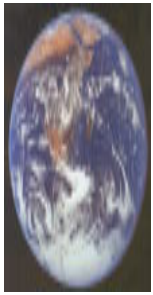
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Risk Area	Rationale
Industry Environment	<ul style="list-style-type: none"><li>• Structural problems in an industry can affect overall risk of lending to an industry – e.g., low returns, high costs, highly competitive, etc.</li><li>• Environmental changes can have negative impact on lending – e.g. trade imbalances, FX deregulation, reduction in trade barriers, and other changes in government policy</li></ul>
Company Position Within the Industry	<ul style="list-style-type: none"><li>• Competitive dynamics can put some companies at a critical advantage or disadvantage. Competitive position is often heavily influenced by threat of new entrant, bargaining power of suppliers and customers, and threat of product substitution</li><li>• Weakness in key areas required to succeed could affect overall risk of lending</li></ul>



# Industry Dynamics

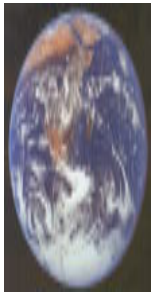
Components	Analysis	Problem Areas (Example)
Industry Cycle	<ul style="list-style-type: none"><li>• Determine market size and growth since the market economy began</li><li>• Assess why market is growing/declining</li><li>• Assess rate of growth</li><li>• Determine how the market is segmented in terms of:<ul style="list-style-type: none"><li>• Customers</li><li>• Geography</li></ul></li><li>• Determine shares of leading competitors and degree of concentration</li><li>• Assess other relevant factors<ul style="list-style-type: none"><li>• Cyclicalities</li><li>• Seasonality</li></ul></li></ul>	<ul style="list-style-type: none"><li>• Shrinking market</li><li>• Volatile market</li><li>• Dominant competitors forcing out smaller ones</li><li>• Key competitors have differentiated product with strong loyalties</li></ul>



# Industry Dynamics (Cont.)

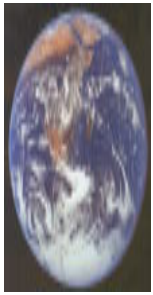
Components	Analysis	Problem Areas (Example)
Regulatory Factors	<ul style="list-style-type: none"><li>• Review regulations which govern industry</li><li>• Review bodies that control regulations</li><li>• Review recent changes and determine likelihood and nature of future changes</li><li>• Understand company's ability to influence change</li></ul>	<ul style="list-style-type: none"><li>• Elimination of price controls leading to competition</li><li>• Government controls key licenses required and expensive to obtain</li><li>• New players enter market</li><li>• Additional risk exposure from deregulation of FX markets</li><li>• Prices control on key inputs lifted</li><li>• New burdensome regulations passed, e.g., environmental laws</li></ul>





# Industry Dynamics (Cont.)

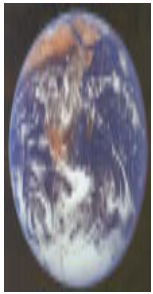
Components	Analysis	Problem Areas (Example)
Industry Structure	<ul style="list-style-type: none"><li>• Evaluate industry characteristics and determine key features of each:<ul style="list-style-type: none"><li>• Nature of products</li><li>• Barriers to entry/exit</li><li>• Economies of scale</li><li>• Substitutes</li><li>• Capital requirements</li></ul></li><li>• Determine structural implications of industry characteristics<ul style="list-style-type: none"><li>• Distribution channels</li><li>• Level of fixed costs and overcapacity</li></ul></li></ul>	<ul style="list-style-type: none"><li>• Commodity like product leading to low profit margins</li><li>• Low barriers to entry resulting in over capacity</li><li>• Supply interruption</li><li>• Over reliance on few, weak suppliers</li><li>• Buyer concentration</li><li>• Certain competitors have locked up key distribution channels</li></ul>



# Financial Condition

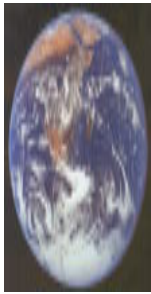
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Risk Area	Rationale
Profitability	<ul style="list-style-type: none"><li>• Indicates operating success, growth potential and competitive position</li><li>• Often numbers reported are inaccurate or manipulated</li></ul>
Liquidity	<ul style="list-style-type: none"><li>• Determines ability to meet obligations – operating expenses, debt service, supplies, credit, etc.</li></ul>
Leverage	<ul style="list-style-type: none"><li>• Determines degree of financial risk and ability to absorb business risk</li><li>• Is a sign of owners' commitment to the business</li><li>• Excess leverage is often a key cause of business failure</li></ul>



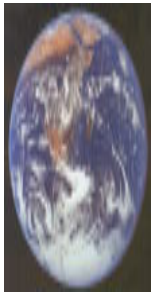
# Financial Condition

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Profitability	<p>Financial ratios</p> <ul style="list-style-type: none"><li>• Return on assets</li><li>• Return on sales</li><li>• Return on equity</li><li>• Operating Profit/Sales</li></ul> <p>Profit and loss statement analysis</p> <p>Quality of A/R</p> <p>Inventory quality</p> <p>Fixed asset quality</p>	<ul style="list-style-type: none"><li>• Complete financial spreads</li><li>• Verify profitability information and determine accuracy</li><li>• Perform trend analysis</li><li>• Compare figures with other companies in industry</li><li>• Perform site visits to assess inventory and fixed asset quality</li><li>• Determine quality of A/R</li></ul>	<ul style="list-style-type: none"><li>• Declining revenue</li><li>• Increasing costs</li><li>• Payroll</li><li>• Financing</li><li>• Cost of goods</li><li>• Depreciation</li><li>• Insufficient profits to support growth</li><li>• Insufficient scale—excess fixed costs</li><li>• Poor quality receivables</li><li>• Insufficient inventory to meet demand</li><li>• Outdated production</li></ul>



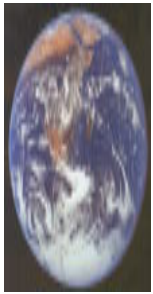
# Financial Condition (Cont.)

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Liquidity	<ul style="list-style-type: none"><li>• Financial ratios</li><li>• Current</li><li>• Quick</li><li>• Inventory turnover</li><li>• A/R days on hand</li><li>• A/P days</li><li>• Interest/operating profit</li><li>• Cash flow</li><li>• Debt service</li><li>• Sources funds analysis</li><li>• Uses fund analysis</li></ul>	<ul style="list-style-type: none"><li>• Evaluate integrity of creditor support</li><li>• Evaluate current asset quality and aging of receivables</li><li>• Evaluate liquidity of investments</li><li>• Assess shareholders' support</li><li>• Willingness to guarantee</li><li>• Willingness to inject additional capital</li><li>• Review cost structure</li></ul>	<ul style="list-style-type: none"><li>• Poor quality current assets</li><li>• Illiquid investments</li><li>• Withdrawal of creditor support</li><li>• Excess debt that drains available cash</li><li>• Withdrawal of shareholder support</li><li>• High cost borrowings/ bunching of payments</li><li>• High payroll/material costs</li></ul>



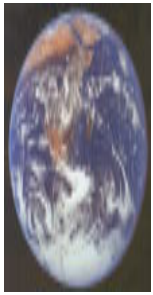
# Financial Condition (Cont.)

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Liquidity, continued	<ul style="list-style-type: none"><li>• Lines of credit</li><li>• Bankers</li><li>• Suppliers</li><li>• Shareholders</li></ul>	<ul style="list-style-type: none"><li>• Develop debt service profile</li><li>• Review investment budget</li><li>• Review intra-group accounts</li><li>• Consolidating statements</li><li>• Receivables and payables to related companies</li><li>• Prices to related companies</li><li>• Dividend payments</li><li>• Owners' salaries/payment</li></ul>	<ul style="list-style-type: none"><li>• Diversion of funds to associated companies/ transfer funding</li></ul>



# Financial Condition (Cont.)

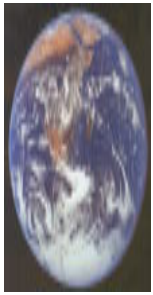
Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Leverage	<ul style="list-style-type: none"><li>• Financial ratios</li><li>• Debt/net worth</li><li>• Debt/assets</li><li>• Interest coverage</li><li>• Rate sensitivity</li></ul>	<ul style="list-style-type: none"><li>• Reconcile net worth</li><li>• Evaluate capital structure</li><li>• Assess creditor/shareholder support</li><li>• Perform rate sensitivity analysis under varying rate scenarios</li><li>• Evaluate</li></ul>	<ul style="list-style-type: none"><li>• Excess debt</li><li>• Withdrawal of support</li><li>• High cost borrowings/ bunching of payments</li><li>• Overvalued equity</li><li>• Over-sensitivity to interest rate swings</li></ul>



# Management Quality

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Risk Area	Explanation
Integrity	<ul style="list-style-type: none"><li>• Forms the whole basis for a sound banking relationship</li><li>• Lack of integrity leads to:</li><li>• Inability to negotiate and reach sound agreements</li><li>• Lack of confidence in application of bank funds</li><li>• Integrity often deteriorates in difficult times</li></ul>
Competence	<ul style="list-style-type: none"><li>• Incompetent management has little chance of competing or addressing and resolving credit problems if they occur</li><li>• Poor management skills lead to credit problems and failures</li></ul>

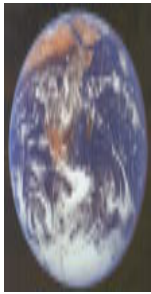


# Management Quality (Cont.)

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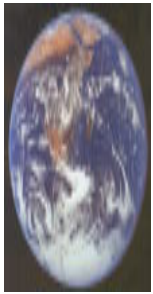
Risk Area	Explanation
Market Confidence	<ul style="list-style-type: none"><li>• Market confidence will influence management/bank power balance</li><li>• If market confidence is strong, the company may be better able to survive a crisis</li><li>• Poor market confidence can quickly cause liquidity problems as creditor support is withdrawn</li></ul>





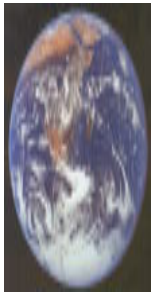
# Management Quality (Cont.)

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Integrity	<ul style="list-style-type: none"><li>• Honesty</li><li>• Quality/reliability of information</li><li>• Meeting of commitments</li><li>• Character and track record</li><li>• Cooperativeness</li><li>• Consistency and quality of communication with bank</li><li>• Supportiveness</li><li>• Willingness to negotiate and be flexible in difficult times</li></ul>	<ul style="list-style-type: none"><li>• Review credit files</li><li>• Note missing information/documentation</li><li>• Frequency/nature of communication</li><li>• Interview branch/regional managers familiar with customer</li><li>• Interview management</li><li>• Test openness</li><li>• Ask for references</li><li>• Develop impressions</li><li>• Interview private sector individuals familiar with management</li></ul>	<ul style="list-style-type: none"><li>• Quality/reliability of information</li><li>• Failure to disclose</li><li>• Misrepresentation</li><li>• Inconsistent information</li><li>• Changing of auditors</li><li>• Refusing audits</li><li>• Meeting commitments</li><li>• Failure to meet with bank</li><li>• Failure to meet contractual obligations</li><li>• Failure to provide documentation</li><li>• Double pledging of security</li></ul>



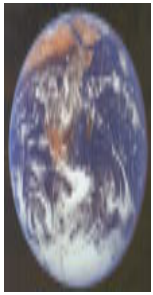
# Management Quality (Cont.)

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Integrity, continued		<ul style="list-style-type: none"><li>• Compare promises with actions</li><li>• Compare information with others</li></ul>	<ul style="list-style-type: none"><li>• Character</li><li>• Obsessive tax avoidance</li><li>• Involved in questionable activities</li><li>• Poor reputation</li><li>• Communication</li><li>• Postponing meetings</li><li>• Supportiveness</li><li>• Will not provide information</li><li>• Will not pledge security</li></ul>



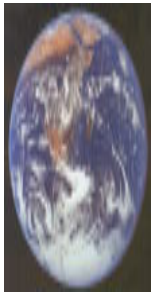
# Management Quality (Cont.)

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Competence	<ul style="list-style-type: none"><li>• Ability</li><li>• Experience</li><li>• Operating skills</li><li>• Financial skills</li><li>• Administrative skills</li><li>• Management structure</li><li>• Management depth</li><li>• Skills</li><li>• Decision-making track record</li><li>• Ability to adapt to changes</li></ul>	<ul style="list-style-type: none"><li>• Interview branch/region bank manager</li><li>• Interview management</li><li>• Obtain key managers' history and determine:<ul style="list-style-type: none"><li>• Education</li><li>• Experience</li><li>• Related skills</li><li>• Review performance</li></ul></li><li>• Profits, growth, direction of trends</li><li>• Compared with other companies</li></ul>	<ul style="list-style-type: none"><li>• Experience</li><li>• Lack of relevant experience</li><li>• Inability to manage</li><li>• Skills</li><li>• Management structure</li><li>• Poor controls</li><li>• Lack of key functions</li><li>• Lack of depth</li></ul>



# Management Quality (Cont.)

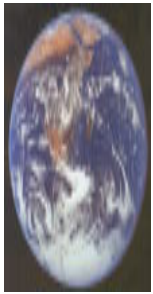
Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Competence, continued		<ul style="list-style-type: none"><li>· Review organization chart</li><li>· Determine span of control</li><li>· Interview individuals familiar with management</li><li>· Review risk profile &amp; investments, debt/leverage</li><li>· Compare impressions with other creditors</li></ul>	<ul style="list-style-type: none"><li>· Decision-making</li><li>· Autocratic style</li><li>· Lack of MIS/analysis</li><li>· Unwilling to make difficult decisions (cost cutting, etc.)</li><li>· High-risk investments</li></ul>
Market Confidence	<ul style="list-style-type: none"><li>· Market reputation</li><li>· Length of management experience</li></ul>	<ul style="list-style-type: none"><li>· Interviews</li><li>· Time in business</li><li>· Group memberships</li></ul>	<ul style="list-style-type: none"><li>· Management disliked by competitors who may spread rumors</li><li>· Out-of-favor politically</li><li>· Poor reputation</li></ul>



# Collateral Realization

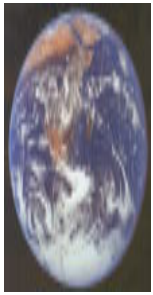
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Risk Area	Rationale
Control	<ul style="list-style-type: none"><li>· Without proper documentation, the bank has no claim on collateral</li><li>· Without ability to execute claim, collateral cannot be realized</li></ul>
Net Liquidation Value	<ul style="list-style-type: none"><li>· Low liquidation values may not cover outstanding debts</li><li>· High liquidation costs will reduce net amount received</li><li>· Collateral quality may deteriorate over time</li><li>· Money has time value</li></ul>



# Collateral Realization (Cont.)

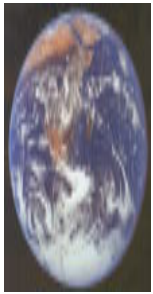
Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Control	<ul style="list-style-type: none"><li>• Perfection</li><li>• Legal rights</li><li>• Documentation adequacy</li><li>• Double pledged collateral</li><li>• Fraud</li><li>• Insurance policy</li><li>• Executability</li><li>• Ability to obtain favorable judgment</li><li>• Ability to take possession</li><li>• Length of legal process</li></ul>	<ul style="list-style-type: none"><li>• Verify documentation</li><li>• Collateral perfection</li><li>• Documentation completeness</li><li>• Documentation integrity</li><li>• Insurance policy and documentation</li><li>• Assess customer's lobbying power with legal authorities, local potential buyers</li><li>• Conduct site visit(s) to verify collateral existence</li></ul>	<ul style="list-style-type: none"><li>• Legal rights</li><li>• Land title not pledged</li><li>• Bank has second priority or is subordinated</li><li>• Documentation adequacy</li><li>• Lacking notary</li><li>• Missing signatures</li><li>• Incomplete documentation</li><li>• Lacking stamp duty</li><li>• Outdated, past due</li></ul>



# Collateral Realization (Cont.)

---

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Control, continued		<ul style="list-style-type: none"><li>· Review recent trends in legal execution</li><li>· Assess length of time to complete legal action</li></ul>	<ul style="list-style-type: none"><li>· Fraud</li><li>· Criminal proceedings</li><li>· Insurance does not cover exposure</li><li>· Ability to obtain favorable judgment</li><li>· Customer has strong lobbying power</li><li>· Judge sympathetic towards customer</li></ul>

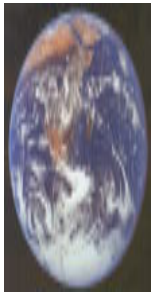


# Collateral Realization (Cont.)

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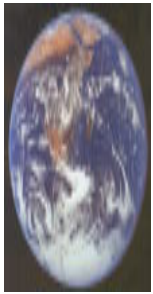
Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Control, continued			<ul style="list-style-type: none"><li>· Ability to take possession</li><li>· Missing security</li><li>· Difficulty in evicting squatters</li><li>· Collateral transferred</li><li>· Collateral immobile</li><li>· Length of legal process</li><li>· Documentation</li><li>· Lobbying conflicts</li><li>· Slowness of due process</li></ul>





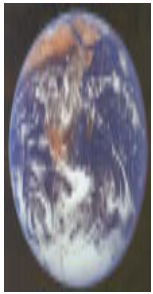
# Collateral Realization (Cont.)

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Net Liquidation Value	<ul style="list-style-type: none"><li>· Liquidation value</li><li>· Quality</li><li>· Quantity</li><li>· Time of sale</li><li>· Market price dynamics</li><li>· Opportunity cost</li><li>· Technology replacement</li><li>· Long legal process</li></ul>	<ul style="list-style-type: none"><li>· Use assessor to value collateral</li><li>· Quality and quantity</li><li>· Market demand</li><li>· Review recent cases</li><li>· Assessed value vs. sale value</li><li>· Change in sale value</li><li>· Time to sell</li></ul>	<ul style="list-style-type: none"><li>· Collateral is of poor quality or perishable</li><li>· Quantity not sufficient to cover exposure</li></ul>



# Collateral Realization (Cont.)

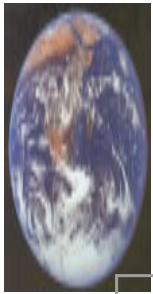
Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Net Liquidation Value, continued		<ul style="list-style-type: none"><li>· Review economic conditions</li><li>· Determine overall likely length of sale</li><li>· Auction process</li><li>· Auction success/failure</li><li>· Sale on secondary market</li><li>· Select appropriate discount rate</li><li>· Determine net liquidation value</li></ul>	<ul style="list-style-type: none"><li>· Market demand</li><li>· No market for goods</li><li>· Collateral highly specialized</li><li>· Value too great—few can afford</li><li>· Borrower has influence over potential buyer</li><li>· Collusion against bank</li><li>· Market price dynamics</li><li>· Volatility</li><li>· Inflation</li><li>· Rapid depreciation</li></ul>



# Collateral Realization (Cont.)

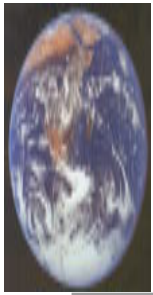
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Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Net Liquidation Value, continued			<ul style="list-style-type: none"><li>· Opportunity cost—value increases/decreases over time</li><li>· Technology—collateral becomes obsolete</li><li>· Legal process</li><li>· Erodes collateral value</li><li>· Market could change during process</li></ul>



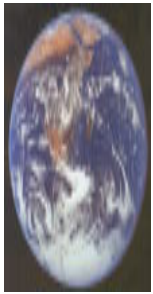
# Industry Dynamics

Components	Analysis	Problem Areas (Example)
Excessive and Unacceptable Risk	<ul style="list-style-type: none"> <li>Shrinking market; highly cyclical and concentrated</li> <li>Severe structural problems</li> <li>Unfavorable regulatory environment</li> </ul>	<ul style="list-style-type: none"> <li>Company severely disadvantaged</li> <li>No strategy</li> <li>Alliances impair market position</li> </ul>
High Risk	<ul style="list-style-type: none"> <li>No market growth, cyclical and concentrated</li> <li>Unattractive structure</li> <li>Worsening regulatory environment</li> </ul>	<ul style="list-style-type: none"> <li>Weak when measured against Key Success Factors (KSFs)</li> <li>Poor strategy</li> <li>Alliances weaken position</li> </ul>
Moderate Risk	<ul style="list-style-type: none"> <li>Slowing growth, signs of increasing cyclical</li> <li>Emerging structural concerns</li> <li>Neutral regulatory environment</li> </ul>	<ul style="list-style-type: none"> <li>Slightly disadvantaged against Key Success Factors (KSFs)</li> <li>Strategy only partially addresses weaknesses</li> <li>Neutral alliances</li> </ul>
Low and Acceptable Risk	<ul style="list-style-type: none"> <li>Growing, attractive market</li> <li>Attractive structure</li> <li>Favorable regulatory environment; no expected change</li> </ul>	<ul style="list-style-type: none"> <li>Well positioned</li> <li>Practical, achievable strategy</li> <li>Favorable alliances</li> </ul>



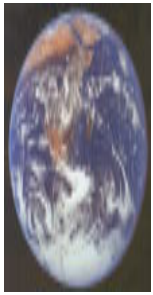
# Financial Condition

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Excessive Risk & Unacceptable Risk	<ul style="list-style-type: none"> <li>Negative ratios, declining trend</li> <li>Increasing cost ratio, declining revenue ratios</li> </ul>	<ul style="list-style-type: none"> <li>Debt/Service below 1.00</li> <li>Current ratios below 0.75</li> <li>Declining trend</li> <li>Well below industry average</li> </ul>	<ul style="list-style-type: none"> <li>Debt/Tangible Net Worth &gt; 5.00</li> <li>Owners not willing to inject equity</li> <li>Large amount of short-term debt supporting fixed assets</li> </ul>
High Risk	<ul style="list-style-type: none"> <li>Profit ratios probably negative</li> <li>Flat trend</li> <li>Cost ratios high, but not increasing</li> </ul>	<ul style="list-style-type: none"> <li>Debt/Service well below 1.00</li> <li>Current ratios below 0.75-1.00</li> <li>Declining trend</li> <li>Below industry average</li> </ul>	<ul style="list-style-type: none"> <li>Debt/Tangible Net Worth 2.00-3.00</li> <li>Owners willing to provide limited support</li> <li>Short-term debt financing fixed working capital</li> </ul>
Low Risk & Acceptable Risk	<ul style="list-style-type: none"> <li>Positive ratios, well above industry average</li> <li>Flat increasing trend</li> </ul>	<ul style="list-style-type: none"> <li>Debt/Service above 2.00</li> <li>Strong current ratio</li> <li>Above industry average</li> </ul>	<ul style="list-style-type: none"> <li>Debt/Tangible Net Worth below 2.00</li> <li>Strong owner support</li> <li>Appropriate capital structure</li> </ul>



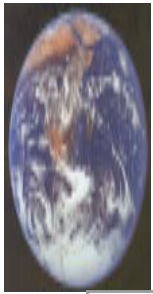
# Management Quality

Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Excessive Risk & Unacceptable Risk	<ul style="list-style-type: none"><li>· Never meets commitments</li><li>· Poor quality, unreliable information</li><li>· Refuses to support relationship</li></ul>	<ul style="list-style-type: none"><li>· No relevant experience/skills</li><li>· No vision</li><li>· No depth</li><li>· Inappropriate organization structure</li><li>· Aggressive risk taker</li></ul>	<ul style="list-style-type: none"><li>· Allied against current administration</li><li>· Poor reputation causing loss of credit</li></ul>
High Risk	<ul style="list-style-type: none"><li>· Rarely meets commitments</li><li>· Information is of low quality, low reliability</li><li>· Weak relationship support</li></ul>	<ul style="list-style-type: none"><li>· Limited experience/skills</li><li>· Limited vision</li><li>· Limited depth</li><li>· Poor structure</li><li>· Risk taker</li></ul>	<ul style="list-style-type: none"><li>· Recent problems diminishing reputation</li></ul>



# Management Quality

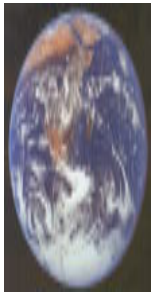
Risk Area	Strength Measures	Analysis	Problem Areas (Example)
Medium Risk	<ul style="list-style-type: none"><li>• Generally meets commitments</li><li>• Reasonable quality of information, generally reliable</li><li>• Supports relationship</li></ul>	<ul style="list-style-type: none"><li>• Moderate experience/skills</li><li>• Moderate depth</li><li>• Some vision</li><li>• Adequate structure</li><li>• Risk neutral</li></ul>	<ul style="list-style-type: none"><li>• Neutral reputation</li></ul>
Low & Acceptable Risk	<ul style="list-style-type: none"><li>• Always meets commitments</li><li>• Quality, reliable information</li><li>• Strong relationship support</li></ul>	<ul style="list-style-type: none"><li>• Experience/skilled</li><li>• Deep management team</li><li>• Good structure</li><li>• Risk averse</li></ul>	<ul style="list-style-type: none"><li>• Strong reputation</li></ul>



# Collateral Realization

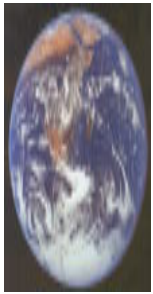
Components	Analysis	Problem Areas (Example)
Excessive and Unacceptable Risk	Collateral not perfected Executability severely impaired	Collateral cover below 50%
High Risk	Perfection is weak Executability complex	Collateral cover 50% - 75%
Medium Risk	Perfection adequate Potential executability issues	Collateral cover 75% - 100%
Low and Acceptable Risk	Strong perfection No executability complications	Collateral cover above 100%





# Example of Risk Acceptance Guidelines

Foundation	Common Performance Categories
Industry	Specific industry risk acceptance standards are usually not set. Instead, others are altered for specific industries.
Financial Condition	<ul style="list-style-type: none"><li>• Leverage</li><li>• Liquidity</li><li>• Performance</li></ul>
Management Quality	<ul style="list-style-type: none"><li>• Years in business</li><li>• Management depth</li></ul>
Security Realization	<ul style="list-style-type: none"><li>• Net Liquidation Value</li><li>• Control</li><li>• Executability</li></ul>



# Cash Flow Choices

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- Investing
- Financing
- Operations

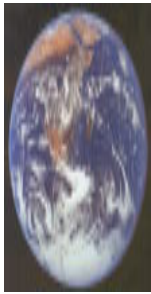


# Cash Flow Analysis

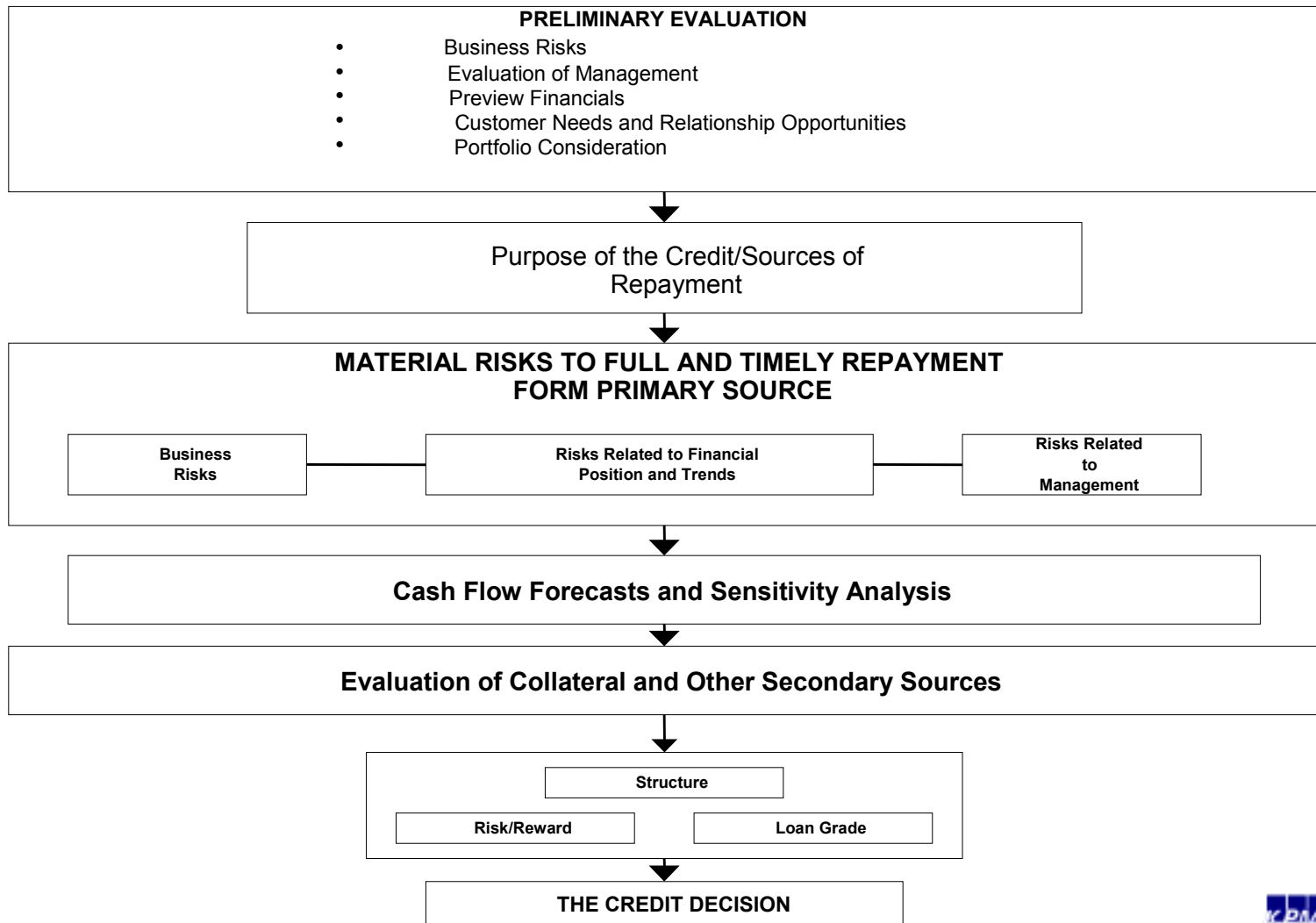
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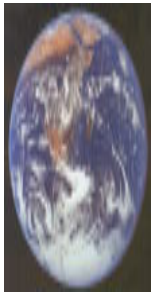
## Loan Repayment Sources

- Cash from earnings
- Cash from conversion of seasonal assets
- Cash from sale of assets
- Cash from new equity or guarantors' collateral is secondary source



# Credit Decision Process





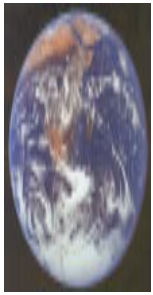
# The Steps in the Credit Methodology Decision Tree

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1. Check on the viability of the company and the transaction.
  - Viable. Continue credit investigation and analysis
  - Not viable. Reject the credit and terminate the analysis. Report on reasons for rejection.
2. Does the company have reliable, published financial statements?

**Yes:**

- Spread the financial statements in a common size, IAS format.
- Conduct credit investigation at the business of the customer. Verify the reason for the application of loan funds. Build a proforma financial projection of balance sheet and income statement.
- Check the collateral. Is it available, viable and realizable?
- Conduct ratio analysis and cash flow analysis. Is cash flow sufficient to repay the loan?
- Compute the liquidation value of the collateral under the distress conditions of a forced sale.

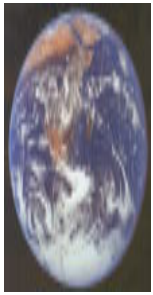


# The Steps in the Credit Methodology Decision Tree (cont.)

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***No, Conduct fundamental credit investigation as described below:***

- Check the collateral. Is it available, viable and realizable?
  - Build a proforma financial projection model as in Module Two.
  - Conduct ratio analysis and cash flow analysis based upon management's information and projections
  - Compute the liquidation value of the collateral under the distress conditions of a forced sale.
3. Assemble documentation, copies of financial records and bank statements and appraisals of property and collateral. Structure and price the credit facility.



# Preparing the Credit Approval Package

## Credit Approval Steps

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### Purpose of Credit Request

- Reason for request
- Brief description of borrower
- History of relationship

### Summary Risk Assessment Form

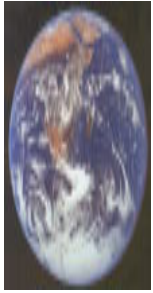
- Summary of each credit foundation, Industry, Management, Financial condition, Collateral
- Overall risk
- What could go wrong

### Credit Requirements

- Summary of borrower requirements, based on cash flow
- Sensitivity of borrower analysis based on projections

### Credit Recommendations

- Facility amount
- Key reasons for approval
- Structural parameters

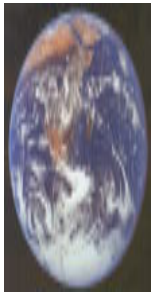


# Key Supporting Documents

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- Credit approval package
- Basic loan application
- Financial spreadsheets
- Projections
- Security documentation checklist
- Other relevant documents





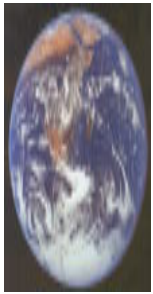
# Credit Approval

**THE OBJECTIVE OF THE CREDIT APPROVAL PROCESS IS TO CONTROL RISKS WITHIN POLICY GUIDELINES WHILE MAINTAINING A STREAMLINED PROCESS...**

- Ensure that all credit decisions meet required policy guidelines and are based on sound credit judgment
- Require higher approval for higher risk to ensure that senior management approves the highest risk credits
- Require multiple signatures to ensure that credit decisions are made with the “collective wisdom” of a group of experienced bankers and to enforce the first level of control over the credit process
- Ensure individual accountability so that each and every approving officer is fully responsible for the credit decision made, and exercises required due diligence in approving loans

## **Balance level of control with efficiency**

- Achieve some degree of decentralization to avoid excessive delays in approval times
- Higher concentration of exposure in a relatively few loans allows banks to more easily balance control and efficiency (see facing page)



# Credit Approval (Cont.)

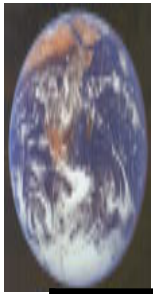
**THE KEY DEVELOPMENTAL ISSUES FOR APPROVAL AND EXPOSURE CONTROL ARE OF GREAT IMPORTANCE FOR MOST BANKS...**

KEY APPROVAL ISSUES	
KEY ISSUES	COMMENTS
♦ Delegating Authority	♦ Is too much authority concentrated at the top ♦ Should Credit Policy Committees have approval authority?
♦ Approving Frequency	♦ How often should Credit Approval Packages (CAPs) be reviewed and approved?
♦ Controlling Approvals	♦ What controls over the approving process are required?
♦ Approving Exceptions and Problem Loans	♦ Should exceptions and problem loans require higher approval? ♦ Exception process - required signature(s) accountability, transparency, could discourage insider loans
♦ Approving Groups	♦ What are necessary controls over availment to minimize mistakes?
♦ Modifying Facilities	♦ Should high and low risk facility modifications require different approval levels?



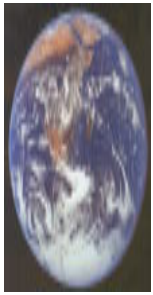
# Basic Classification of Loans:

Loan Type	Primary Repayment Source	Secondary Sources of Repayment
Seasonal Loan	Cash from seasonal conversion of assets	A. Sale of Assets for Cash B. Cash Flow C. Refinance by Third Party D. Equity Injection
Term Loan	Cash from earnings	A. Sale of assets for cash B. Refinance by third party C. Equity injection
Bridge Loan	Cash from the event—either refinancing or asset sale	A. Cash flow B. Sales of assets for cash C. Refinance by third party D. Equity injection
Permanent Working Capital Loan	<b>Near Term:</b> Revolver <b>Ultimate Repayment:</b> Cash From Earnings	A. Sale of Current or Fixed Assets For Cash B. Refinance by Third Party C. Equity Injection D. Term, with Periodic Amortization Through Cash Flow



# Basic Classification of Loans:

Type of Loan/Purpose	Repayment	Analysis
<b><u>Short term</u></b> <ul style="list-style-type: none"> <li>Seasonal working capital line of credit; letters of credit; transactional</li> </ul>	<ul style="list-style-type: none"> <li>Loan is repaid when borrower sells inventory and collects receivables</li> </ul>	<ul style="list-style-type: none"> <li>Working capital: projections should show cash-to cash cycle; the timing and reliance on inventory as support.</li> <li>Note expected peak loan needs, timing of draw-downs, link between bank loans and supplier credit</li> </ul>
<b><u>Bridge Loans</u></b> <ul style="list-style-type: none"> <li>Project financing; construction</li> </ul>	<ul style="list-style-type: none"> <li>Expected longer-term refinancing or take-out event</li> <li>Maturities tailored to the refinancing event</li> </ul>	<ul style="list-style-type: none"> <li>Probability that refinancing event will occur (Event analysis)</li> <li>Analyze borrower's ability to repay if refinancing fails</li> </ul>
<b><u>Medium term loans</u></b> <ul style="list-style-type: none"> <li>Equipment and vehicle acquisition; lease</li> </ul>	<ul style="list-style-type: none"> <li>Repayment based upon cash flow of firm</li> <li>Maturities roughly match the useful lifetime of the asset or the legal tax amortization period</li> </ul>	<ul style="list-style-type: none"> <li>Incremental cash flow to firm due to the equipment</li> <li>Business and industry analysis: competitiveness</li> <li>Sensitivity analysis on cash from operations</li> </ul>
<b><u>Term loans</u></b> <ul style="list-style-type: none"> <li>Financing the purchase of fixed assets or broad expansion of the production lines; maturities over 1 year less than 10.</li> </ul>	<ul style="list-style-type: none"> <li>Firm must have predictable, long-term sources of cash.</li> <li>Cash flow (shelter) from depreciation expense</li> <li>Long term tenor to match the useful lifetime of the assets</li> </ul>	<ul style="list-style-type: none"> <li>Long term profitability of the firm.</li> <li>Business and industry analysis:</li> <li>Competitive strength within the industry.</li> <li>Sensitivity analysis based upon state of the economy and other assumptions; breakeven analysis</li> </ul>



# Seasonal Loans

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## **Purpose**

- To finance season increases in everyday and receivables

## **Repayment**

- Cash from conversion of seasonal assets

## **Structure Considerations**

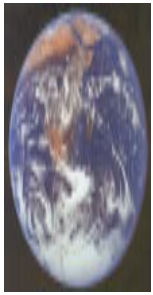
- Maturity should correspond with seasonal low point
- Structure to track seasonal patterns with cleanup or seasonal ceiling
- May want to sue guidance line to track seasonal needs
- Normally secured; with annual lien search

## **Collateral**

- May want to receive receivable testing at seasonal peak

## **Analysis**

- Focus on peaks and low points of current assets and liabilities
- Monthly or quarterly projections are essential
- Close monitoring- deviation from projected patterns triggers investigation



# Seasonal Loans (cont.)

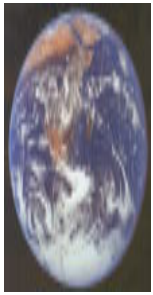
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## Monitoring

- Deviation from expected peaks and low points should be investigated
- Quarterly statements should be received; at minimum, receivables, inventory trade debt and accruals should be monitored

## Typical Risks

- Product cannot be sold because of style, demand or obsolescence
- Products or services cannot be produced because of cost problems, labor, machinery, supplies, other problems
- Receivables cannot be collected
- Trade not fully paid (may create problems for next season)
- Earnings insufficient to repay bank

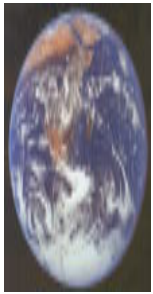


# Seasonal Loans (cont.)

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## **Common Lending Errors**

- Advances under seasonal loans go to other purposes
- Lender overlooks need for underlying cash flow as a secondary source; if the borrower cannot sell peak season inventory, how will the bank?
- Financing a 'speculative' position



# Bridge Loans

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## Purpose

- To finance seasonal increases in everyday and receivables

## Repayment

- Refinancing
- New equity
- Sale of non-current assets

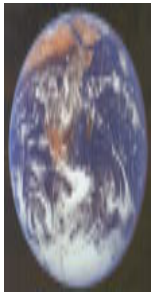
## Structure Considerations

- Maturity should coincide with the anticipated event **Analysis** Focus on likelihood that the event will occur and repay the debt
- Focus on the borrower's ability to service the debt if the event does not occur
- The bank needs to be prepared to take on term debt under the scenario which causes the event not to occur under what may be an impaired situation

## Monitoring

- Varies widely according to circumstances; an interim construction loan requires extensive monitoring, other types may not



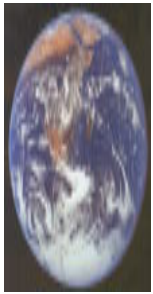


# Bridge Loans (cont.)

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## Typical Risks

- Repayment event may not occur, and the borrower may not have the ability to service the debt.
- Asset sale at less than anticipated price.
- Prior loans or divergent claims such as in a divorce situation.
- Uninsured damage to the asset for sale.
- Lack of a firm commitment to refinance.
- Inability to meet contingencies of a refinancing commitment.
- Inability or unwillingness of other lender to meet its commitment.
- Abrupt increase in interest rates.
- Inability to sell additional equity



# Bridge Loans (cont.) & Permanent Working Capital Loans

---

## **Common Lending Errors**

- Not properly analyzing the secondary repayment source, which is generally long-term cash flow.
- Overvaluing an asset being sold.
- Failure to consider all contingencies which could preclude the repayment event from occurring.
- Inadequate refinancing because of cost overruns, accumulation of interest, etc.
- Inadequate risk-reward relationship, (a one-time bridge loan to a non-relationship)



# Permanent Working Capital Loans (Cont.)

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## Purpose

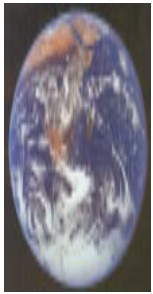
- To finance a portion of non-seasonal inventory and receivables

## Repayment

- This is a revolving facility for which repayment is indefinite; eventual repayment sources may include:
- Conversion of the facility to a term loan or, alternately, a step-down in the borrowing base; in either case, repayment coming from cash in profits
- Refinancing
- Infusion of equity
- Liquidation of assets, which is the least desirable

## Structure Considerations

- Advances should be made only on proof of adequate collateral, with an appropriate borrowing base
- Unless capitalization and cash flow are relatively strong and stable, consideration may be warranted for an asset-based loan, including careful monitoring of collateral and a lock-box arrangement
- Covenants should be set at appropriate levels dependent on the point in the company's growth cycle



# Permanent Working Capital Loans (Cont.)

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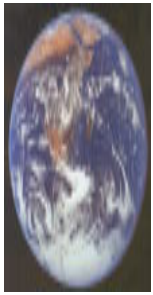
## *Analysis*

### Collateral valuation and control

- Long-term earnings power; the bank may not require immediate amortization but is intensely interested, on an ongoing basis, in the capacity of the borrower to repay the debt . . . i.e., if growth were to stop, does the borrower have the cash flow capacity to term out the debt?

### Borrower's internal controls and reporting systems

- All of the considerations of term loan analysis, including management capacity, industry and business risks, management strategy, competitive situation, market position; the bank is not a factoring company and looks to sustainable earnings power for repayment when requested



# Permanent Working Capital Loans (cont.)

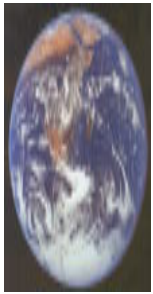
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## **Monitoring**

- Careful, ongoing monitoring of eligibility and borrowing base
- Monthly listings of accounts receivable
- Monthly or quarterly financials should be reviewed
- Audits as appropriate
- If covenants have been properly set, violations should be reviewed as significant
- Violations should be immediately dealt with so the agreement is not demeaned

## **Typical Risks**

- Profits deteriorate and cannot support the debt



# Term Loans

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## **Purpose**

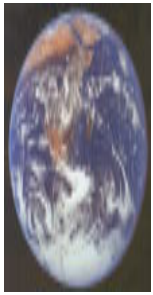
- Purchase fixed assets
- Acquisition financing
- Repay unpaid seasonal loans
- Repay permanent working capital loans at an appropriate time

## **Repayment**

- Cash from profits over more than one year

## **Structural Considerations**

- Term loan agreement should be executed, specifying terms, conditions, responsibilities, and remedies
- Repayment should match purpose, i.e., term should be equal to or less than the life of the asset financed

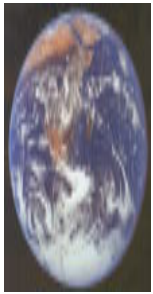


# Term Loans (Cont.)

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## Analysis

- Focus is on long-term earnings stability and potential risks thereto
- Reliance should be placed on historical performance rather than optimistic projections
- Business and industry risks, management risks, and financial risks, as well as mitigating factors, should be carefully analyzed
- Analysis of the borrower's strategy, market position, and competitive position is important
- Sensitivity analysis establishes the margin of error under which the bank will be repaid in a timely manner by the primary repayment source
- Term loans to finance fixed assets should be followed up with the borrower with an ROA analysis (of the assets financed) to assure that the borrower's investments are producing appropriate returns.



# Term Loans (cont.)

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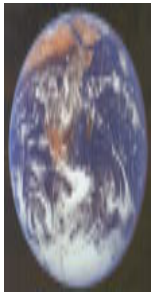
## **Monitoring**

- If covenants have been properly set, violations should be viewed as significant
- Violations should be immediately dealt with so the agreement is not demeaned
- Avoid the “book it and forget it” syndrome. There should be ongoing monitoring of the potential risks analyzed at the time of underwriting

## **Typical Risks**

- Inadequate sales
- Pressure on margins and/or operating expenses
- Inability to reduce overhead in the face of declining sales
- Cash flow applied to growth, without appropriate new equity to support the growth
- Fixed assets become obsolete
- Cash flow diverted from repayment to bank





# Term Loans (cont.)

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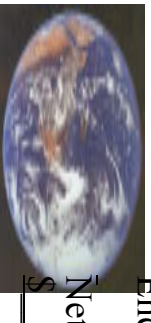
## **Common Lending Errors**

- Failure to understand business and industry risk, and to realize that markets change
- Reliance on optimistic forecasts unsubstantiated by historical performance
- Failure to properly assess management
- Failure to provide an adequate margin of error
- Failure to anticipate additional financing needs
- Overestimating collateral value

# COMMERCIAL COLLATERAL VALUATION

Borrower \_\_\_\_\_

Book or Valuation Valuation	Realization Percentage	Net
Cash – Pledged	\$ _____	\$ _____
Receivable – Aging		
0 – 30		
days		
30-		
60 _____		
60-		
90 _____		
90-		
120 _____		
Over		
120 _____		
Total	\$ _____	\$ _____
Inventory – Book Value		
Raw		
Materials		
In		
Process		
Finished		
Goods		
Retail/Wholesale		
-		
Total	\$ _____	\$ _____
Equipment – Book Value or Appraised Value		
Manufacturing		
Office/Furniture/Fixtures		
Transportation		
Equipment		
Total		
Less: Superior		
Encumbrances		
Net Value	\$ _____	\$ _____



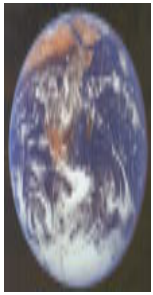
## Real Estate – Appraised Value

Land	_____	_____
Buildings	_____	_____
Leaseholds	_____	_____
Total	_____	_____
Less: Superior Encumbrances	_____	_____
Net Value	\$ _____	
Other Collateral – Securities, etc.	\$ _____	_____

<b>Net</b>	<b>Net</b>	<b>Cost to</b>
<b>Realizable</b>	<b>Valuation</b>	<b>Liquidate</b>
<b>Value</b>		
Recap		
Cash	_____	_____
Accounts Receivable	_____	_____
Inventory	_____	_____
Equipment	_____	_____
Real Estate	_____	_____
Other	_____	_____

Total Net Liquidation Proceeds (A)	\$ _____
Less Gross Loan Balance (B)	_____
Net (Loss) or Collateral Cushion	\$ _____
Collateral Coverage Ratio A + B	_____ %

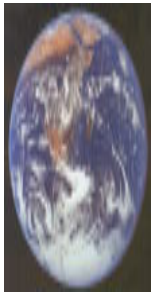




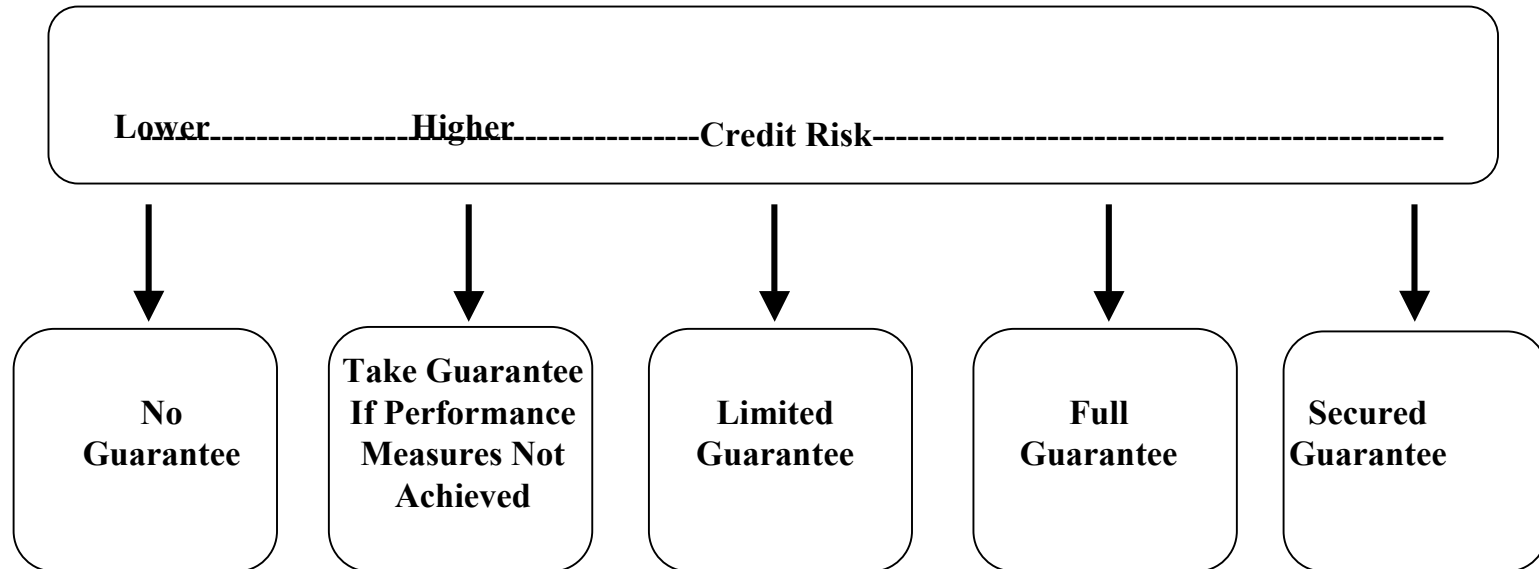
# Guarantors and Co-signers

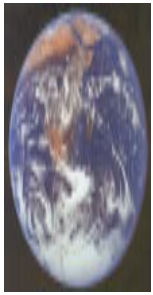
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- Loans should not be underwritten based primarily upon the financial support of guarantors. Collateral and/or guarantor support, while important, are not substitutes for cash flow.
- Guarantees from principals of closely held corporations, joint ventures, partnerships, or sub-S corporations are required.
- Consideration must be evident in the transaction.



# Guarantee Spectrum

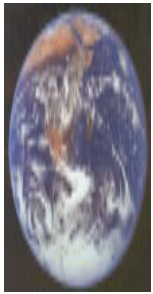




# Loan Agreements

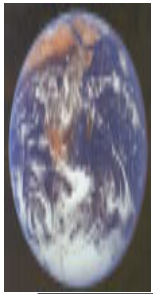
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- Functional Objectives of Loan Agreements
- Preserve the net worth of the borrower
- Full disclosure of the information
- Protect the primary source of repayment (cash flow)
- Preserve the value of the collateral (secondary source of repayment)
- Maintain the quality of management
- Assure the continuance of the legal status
- Maintain adequate growth
- Insure a profit for the bank
- Establish a base for financial performance (a report card for the company's expectations)
- Provide the lender with an early protection trigger to obtain collateral
- Give the lender the rights for early enforcement of collateral if in default
- Loan agreements cannot repay the loan; provide future information or manage the borrower's business.

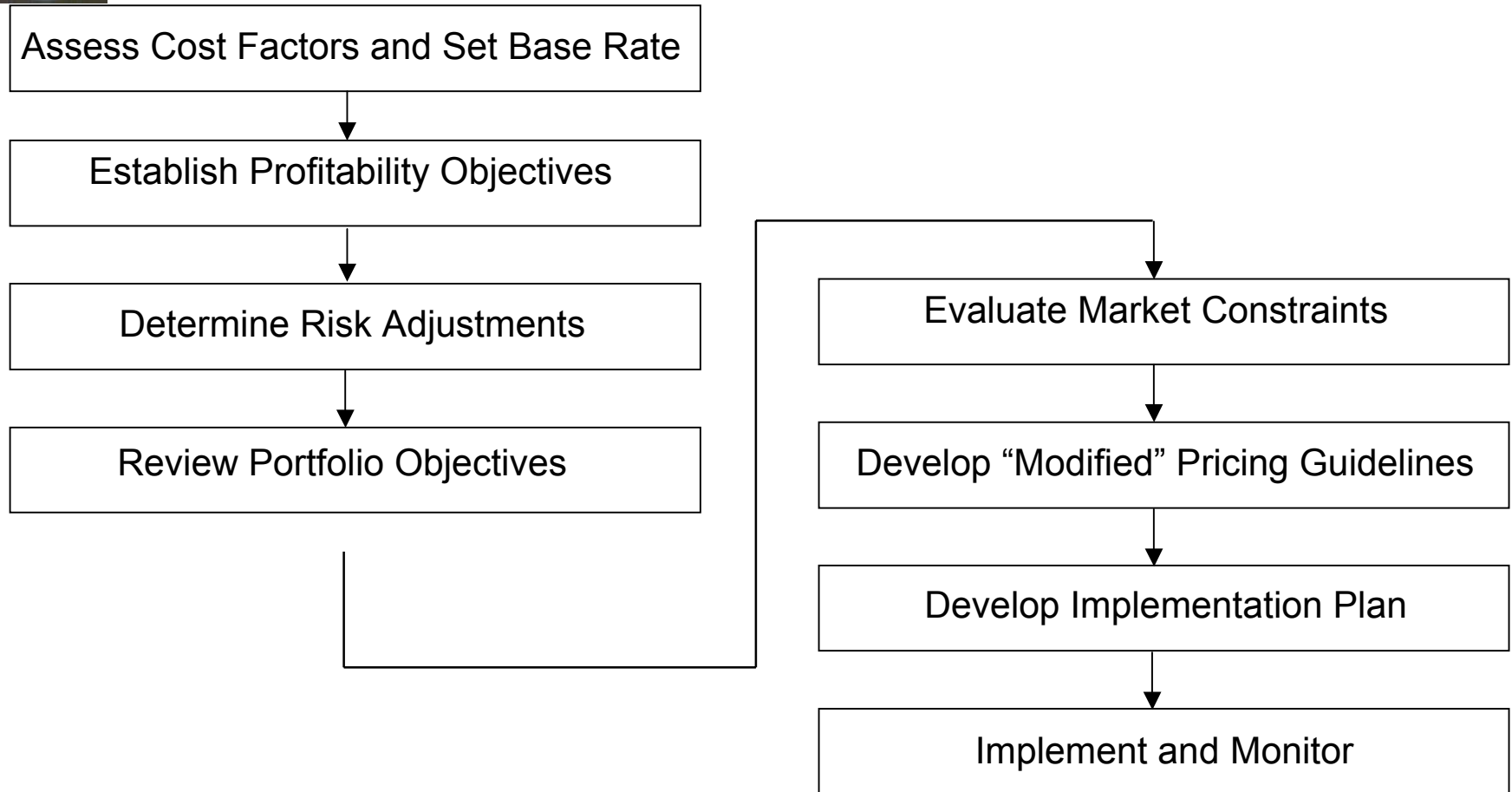


# Typical Loan Agreement Components

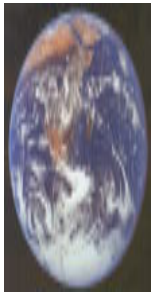
Representation and Warranties	Affirmative Covenants	Negative Covenants	Events of Default	Remedies
<ul style="list-style-type: none"> <li>• Properly incorporated</li> <li>• Power and authority to borrow</li> <li>• Current on taxes</li> <li>• Litigation disclosures</li> <li>• Good title to assets</li> <li>• Assets not pledged except as disclosed</li> <li>• No violation of any other agreement</li> <li>• Has made full financial disclosure</li> </ul>	<ul style="list-style-type: none"> <li>• Submit annual/periodic reporting</li> <li>• Submit period compliance certificates</li> <li>• Maintain corporate existence</li> <li>• Maintain adequate insurance</li> <li>• Maintain assets</li> <li>• Pay taxes</li> </ul>	<ul style="list-style-type: none"> <li>• Financial ratio maximums/minimums</li> <li>• Interest/debt coverage</li> <li>• No additional borrowings</li> <li>• Limits on third party obligations</li> <li>• Limits on capital expenditures</li> <li>• Limits on dividends, stock purchases</li> <li>• Will not pledge assets to other creditors</li> <li>• No mergers/ acquisitions</li> <li>• No sale of assets</li> <li>• No investments in other companies</li> </ul>	<ul style="list-style-type: none"> <li>• Failure to pay principal/ interest</li> <li>• Failure to comply with affirmative/ negative covenants</li> <li>• Incorrect representation or warranty</li> <li>• Default on debt to third party</li> <li>• Bankruptcy</li> </ul>	<ul style="list-style-type: none"> <li>• Declare entire principal and accrued interest immediately due and payable</li> </ul>



# Loan Pricing Methodology

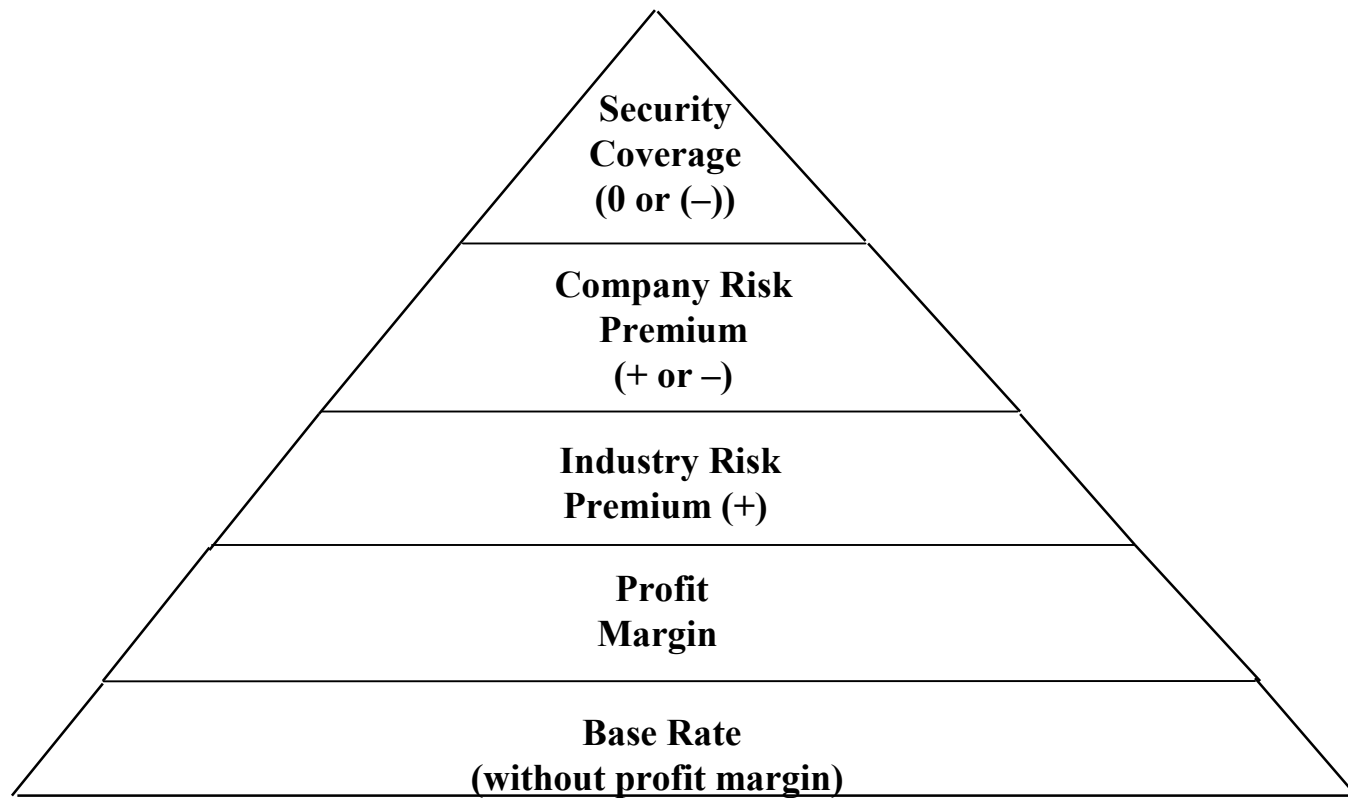


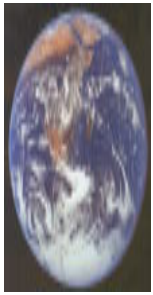




# Risk Adjustment

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# Pricing

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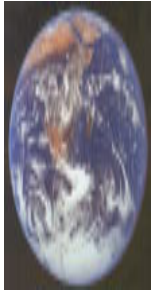
- A Key Portfolio Management Function Often Overlooked is Pricing Guidelines
- Many banks we have diagnosed have poor pricing processes
  - Pricing does not reflect true cost of funds, ignoring marginal cost
  - Pricing is not differentiated according to customer risk
    - Does not encompass servicing cost
    - Marketing costs
    - Administrative costs
- Failure to price using marginal costs of funds is one of the most common mistakes we encounter
- Banks look at pricing on an average basis
- This approach can quickly reduce profitability as cheaper retail deposits and any priority funding are exhausted (see facing page)



# Loan Review vs. Loan Monitoring

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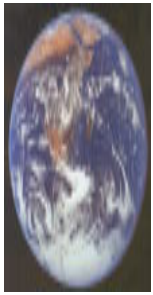
- Loan Review – Strategic Third Party
- Loan Monitoring Tactical Process



# Objective of Loan Review

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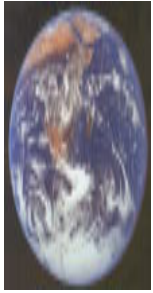
- Evaluate credit quality
- Assess adequacy of the loan loss reserve
- Determine trends
- Identify problems
- Adherence to credit policy
- Portfolio profitability
- Effectiveness of credit administration



# How Loan Review Performs its Function

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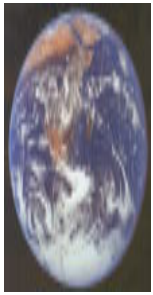
- Determine what is to be reviewed and when, given time and resources
- Loan reviewed should be representative of the portfolio as a whole
- Establish a minimum loan amount for review
- Employ random sampling on a statistical basis
- Industry, geographic, customer concentrations must be detected and examined
- Borrowers with certain financial characteristics must be scrutinized
- Examine branch credits in detail
- Frequency of loan review based on risk rating of a loan
- Monitor situations where corrective action has been recommended



# FIVE Specific Issues When Examining Individual Credits

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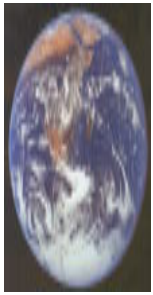
- Credit Quality
- Documentation
- Liquidation of collateral
- Pricing and funds management objectives
- Compliance with policies, laws and regulations



# Portfolio Trends Track

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- Risk ratings
- Classified loans to total loan portfolio
- Concentrations
- Losses and recoveries
- Loan loss provisions
- Loan loss reserve to total loans
- Delinquencies
- Other real estate, non-accruals, restructured loans
- Earnings data
- Marketing data- number of borrowers, account balance totals, etc.

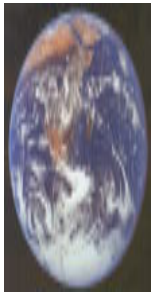


# Contents of the Loan Review Report

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- Scope of examination
- Review of previous exam
- Credit process
- Review
- Accuracy of loan grading system
- Credit policy compliance
- Financial analysis of borrowers
- Problem loan resolution
- Maintaining adequacy of loan loss reserve
- Other items of concern
- Summary/  
recommendations

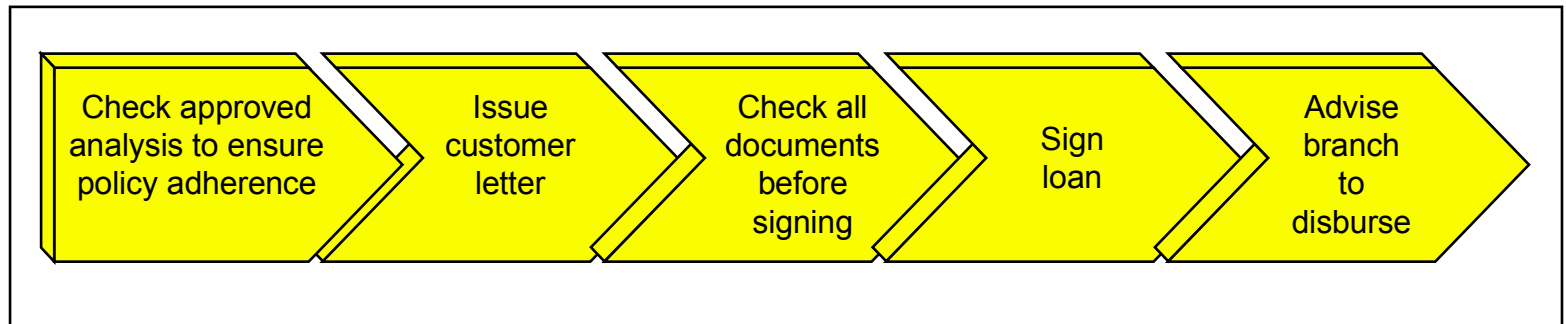




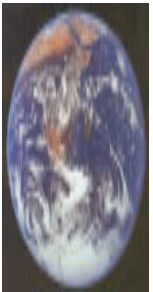
# Disbursement Control

**DISBURSEMENT CONTROL IS CRITICAL TO ENSURE THAT SECURITY AND REQUIRED DOCUMENTATION ARE OBTAINED BEFORE FUNDS ARE DISBURSED...**

## **BASIC DISBURSEMENT CONTROL FLOW**

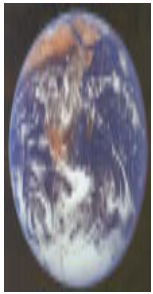


- ◆ If disbursement control is weak, the whole integrity of the credit process can be weakened
  - ◇ Approval Authorities may be circumvented
  - ◇ Corruption and fraud easily exercised



# Credit Approval Memo Sample

<b>CREDIT APPROVAL MEMO (CAM)</b>	
<b>Company Name:</b>	
<b>Date:</b>	<b>CAP NO:</b>
Address the following issues:	
1. <b>Purpose of Credit</b>	
<ul style="list-style-type: none"><li>- Reason for Request</li><li>- Brief Description of Borrower</li><li>- Brief History of Relationship</li></ul>	
2. <b>Risk Analysis</b>	
<ul style="list-style-type: none"><li>- Summary of Each Foundation</li><li>- Overall Risk</li></ul>	
3. <b>Credit Requirement</b>	
4. <b>Credit Recommendation</b>	
<ul style="list-style-type: none"><li>- Facility Amount</li><li>- Why the Loan Should Be Made</li><li>- Structural Parameters</li></ul>	
Preparer:	



# Credit Administration

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**CREDIT ADMINISTRATION IS A NECESSARY FUNCTION THAT SHOULD COVER SEVERAL KEY FUNCTIONS...**

**Conduct Key Exposure Control** usually focuses on availment control and Modifications

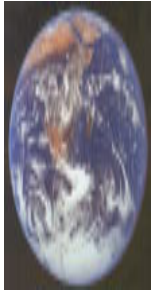
- Availment control should ensure that security and required documentation are obtained before funds are disbursed
- Modification control should ensure any modifications that occur are approved within credit policy

**Maintain Orderly Credit Files** is another vital function

- An organized and easily accessible filing system is critical in supporting sound credit operations
- Documentation files are particularly important for security and confidentiality reasons
- Can be easily overlooked, yet vital for collection

**Impose Tickler Files** will provide necessary control

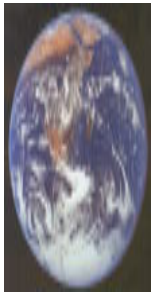
- Ensure documentation does not go stale
- Ensure that prompt notification of credit reviews and renewal dates occurs



# Portfolio Management

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**THE PORTFOLIO MANAGEMENT FUNCTION SHOULD HAVE DEFINED FUNCTIONS RELATED TO CREDIT POLICY, ASSET ALLOCATION AND PRICING...**



# Portfolio Management (Cont.)

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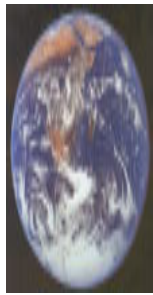
ASSET ALLOCATION STANDARDS ARE A CRITICAL CREDIT MANAGEMENT TOOL...

Portfolio Limits are a key asset allocation control used to contain risks and improve long-term viability

- Avoid catastrophic losses from overexposure in any one risk area
- Diversify the portfolio to reduce concentrations and provide a more stable earning base

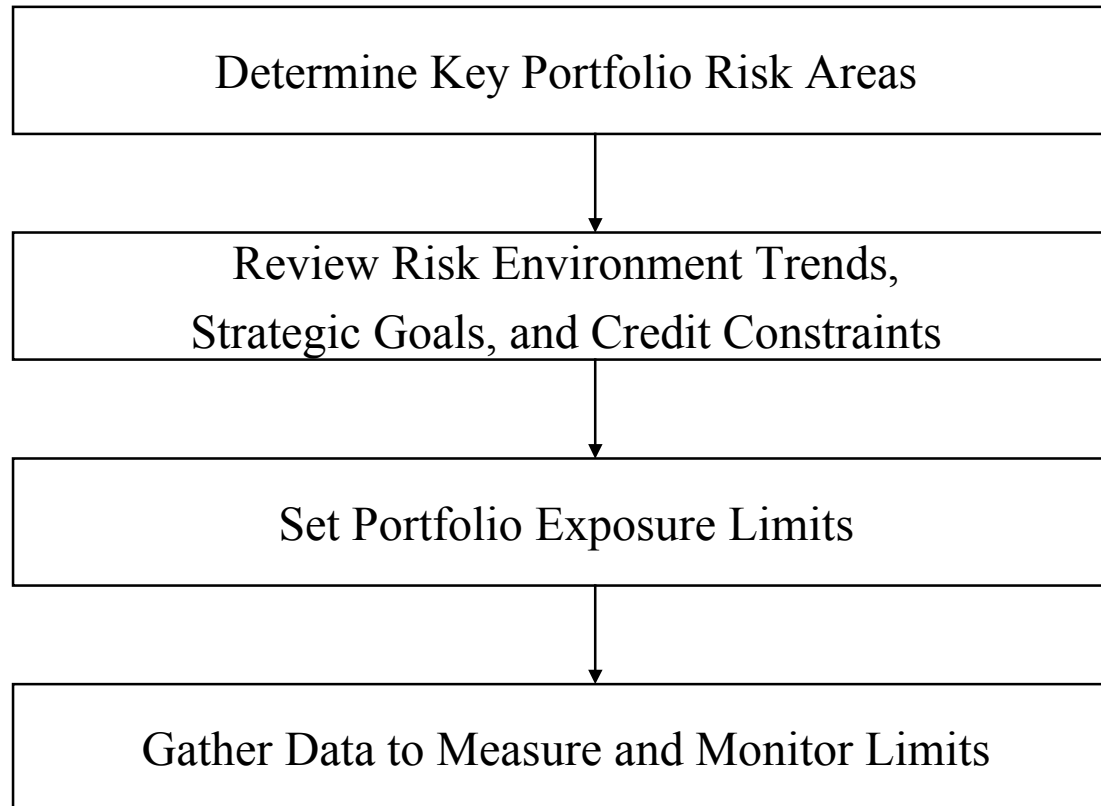
Priority Portfolio Management sets guidelines to productively move the portfolio toward lower risks and higher returns

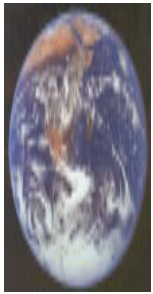
Risk Acceptance Guidelines define performance criteria and structuring requirements for individual credits within risk areas



# Process for Establishing and Implementing Portfolio Exposure Limits

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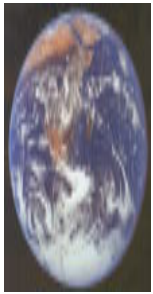




# Portfolio Limits

**MANAGEMENT SHOULD DETERMINE RELEVANT PORTFOLIO LIMITS BASED ON KEY FACTORS RELEVANT TO ITS MARKET...**

Key Factor	Sample Question
Current Risk Environment	<ul style="list-style-type: none"><li>• What key environmental trends are prevalent and how will they impact each risk area?</li></ul>
Growth Goals	<ul style="list-style-type: none"><li>• What is the bank's overall growth objective and what are specific objectives for each risk area?</li><li>• What exposure levels are implied by the growth objectives?</li><li>• Do implied exposure levels conflict with conclusions regarding risk trends?</li></ul>
Government and Developmental Banking Objectives & Regulations	<ul style="list-style-type: none"><li>• What exposure levels do government regulations/objectives imply for key risk areas? What are the implications for other risk areas?</li><li>• Do these exposure levels conflict with the bank's own growth goals and the level of environmental risk?</li></ul>
Market Structure	<ul style="list-style-type: none"><li>• What is the current competitive environment in key risk areas?</li><li>• What are demand trends?</li><li>• How do these trends impact exposure levels?</li></ul>

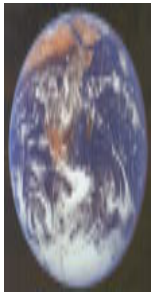


# Portfolio Limits (Cont.)

## KEY RISK AREAS WILL DIFFER BY BANK AND COUNTRY...

Risk Area	Rationale
Single Borrowers	<ul style="list-style-type: none"><li>• Excessive exposure to a single borrower that goes out of business and does not pay could eliminate a year's profit or capital</li><li>• Exposure to large borrowers is difficult to unwind once unforeseen problems emerge</li></ul>
Groups (affiliated borrowers)	<ul style="list-style-type: none"><li>• Same as above</li><li>• Financial problems in only a part of a group's businesses often cause the whole group to fall apart</li></ul>
Industries/ sub-industries	<ul style="list-style-type: none"><li>• Cyclical or systemic structural weaknesses in an industry can result in bankruptcy of all but the strongest companies</li><li>• Industry structural problems impact both first and second way out</li></ul>
Business Segments	<ul style="list-style-type: none"><li>• Economic events can cause entire banking businesses to experience downturns -- e.g., financing real estate, consumer lending</li></ul>
Products (Letters of Credit)	<ul style="list-style-type: none"><li>• Product profitability is generally impacted by a set of structural elements which lead to cyclical performance</li><li>• Over-concentration in any one product could expose the bank to cyclical swings in earnings</li></ul>



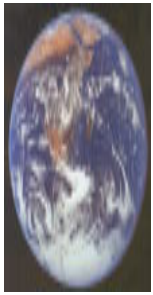


# Credit Monitoring

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## **Credit Monitoring Objective**

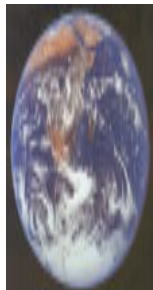
- Detect changes in customer creditworthiness so corrective action can be taken to minimize losses.
- Early detection:
  - Allows the bank to act before assets disappear or lose additional value
  - Improves success chances by early detection of problems and thus necessary remedial action can begin



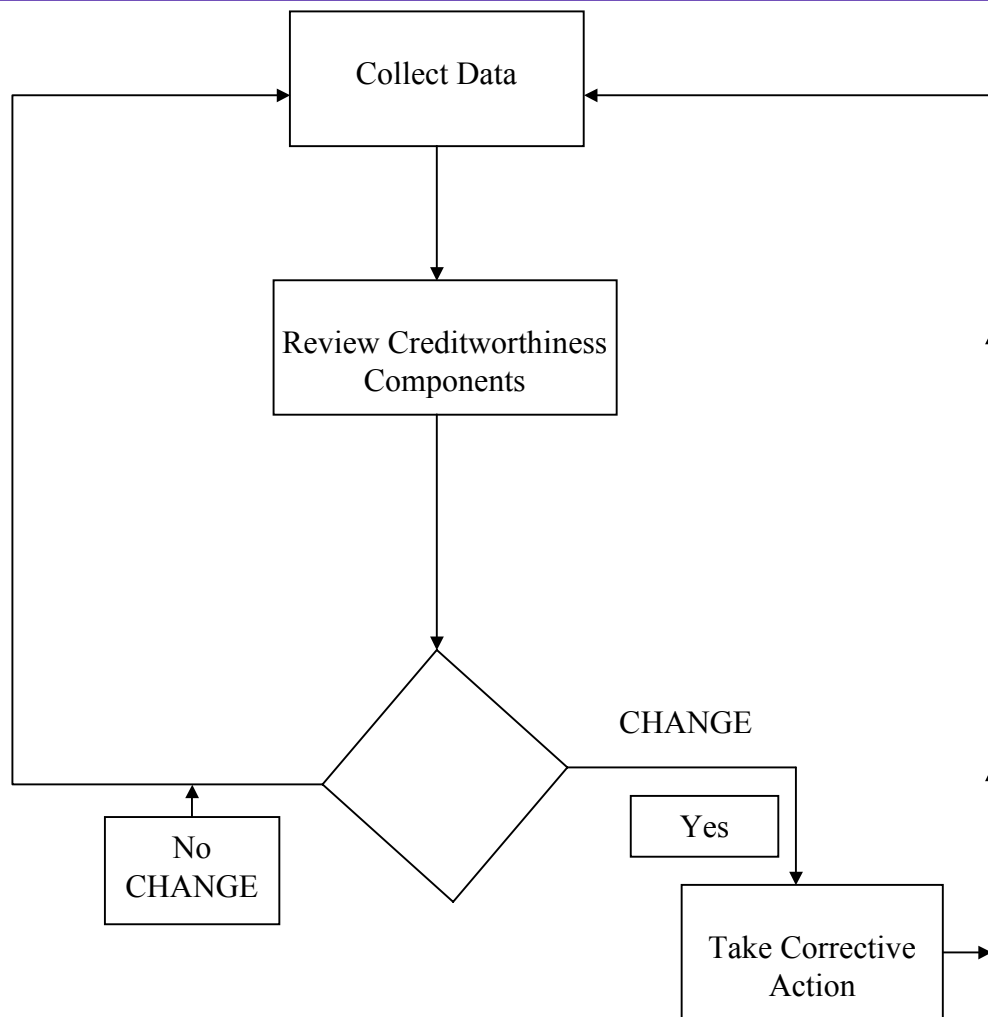
# Credit Monitoring Objective, (Cont'd)

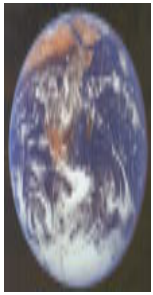
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- Monitoring the four foundations is key to early problem recognition. The four foundations are:
  - Industry Dynamics
  - Financial Condition
  - Management Quality
  - Security Realization
- Upon detection of decline in creditworthiness, immediately take remedial action. For example:
  - Reduce exposure
  - Conduct detailed investigation
  - Increase and improve security
  - Transfer to problem loan unit



# Credit Monitoring Process

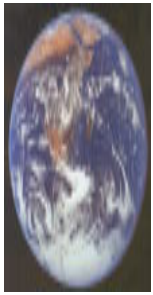




# Loan Monitoring

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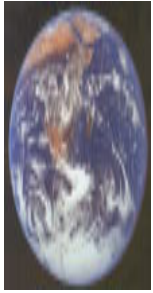
- Use the loan agreement as a monitoring tool
- Document the borrower's compliance with the loan agreement
- Periodically review compliance
  - Is the borrower providing company information in accordance with the loan agreement? E.g., monthly accounts receivable agings or inventory reports.
  - Periodically review the borrower's compliance with warranties contained in the loan agreement
- Bank's credit audit group should also document the borrower's compliance with the loan agreement, independently of the credit department



# Loan Monitoring

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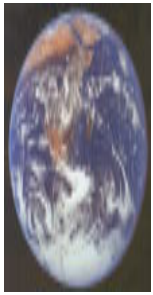
- Review the financial information submitted by the borrower
  - Financial statements (weekly, monthly, quarterly)
  - Order backlog
  - Receivables aging
  - Inventory report
- Are all of these reports in order?
- Are there any surprises?
- Unexpected changes?



# Other monitoring activities

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- Review bank deposits
- Review cash receipts and disbursements
- Conduct site visits (announced and unannounced)
- Conduct lien checks
- Trade creditor checks
- Anticipate problems



# Quarterly Customer Calls & Site Visits

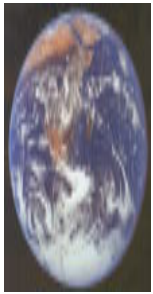
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## Conduct customer calls and site visits to obtain key data

- Problems are often evident here first
- Problems are often disguised in financial statements

## Conduct customer call quarterly.

- Develop a call schedule plan
- Plan other necessary data gathering



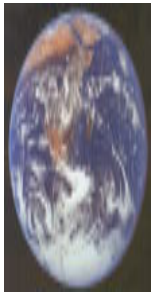
# Monitoring Data Collection

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Ability to service debt is a key measure of creditworthiness

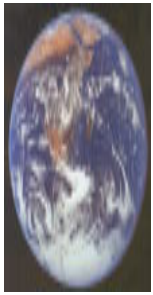
- Key tangible way to measure liquidity and financial condition
- May lead to weakness in other credit foundations
  - Industry Dynamics
  - Financial Condition
  - Management Quality
  - Security Realization





# Required Actions for Non-Payment

Internal	External
<ul style="list-style-type: none"><li>• Notify department management</li></ul>	<ul style="list-style-type: none"><li>• Call customer and request payment within 7 days</li></ul>
<ul style="list-style-type: none"><li>• If not corrected within 15 days, notify credit committee and downgrade classification</li></ul>	<ul style="list-style-type: none"><li>• Increase monitoring<ul style="list-style-type: none"><li>-- update creditor calls</li><li>-- Increase customer calls</li><li>-- check collateral</li></ul></li></ul>



# Customer Classification Plan

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## A standard customer classification system:

- Identifies and isolates early warning signs and triggers corrective action
- Prompts officers to draw conclusions regarding creditworthiness
- Provides a basis for controlling and managing the monitoring process
- Standardizes the measurement of risk and creates a common language for addressing credit issues



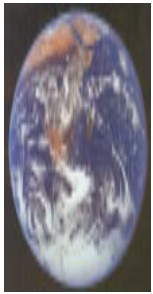
# Standards for Classifying Loans

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Classify loans based on a set of standard guidelines.

Classification of credits is a subjective exercise:

- Financial statements and tools can often be misleading and inaccurate.
- Many required measurements are clearly judgmental.



# Classifications Definitions

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## **Low Risk**

Relationship that represents minimal risk, all credit components are strong now in the foreseeable future

## **Acceptable Risk**

Relationship that represents satisfactory risk with no material weakness apparent

## **Moderate Risk**

Relationship where one or more credit components are weak; although no immediate loss is evident, close monitoring is required

## **High Risk**

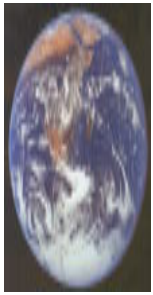
Relationship where material weaknesses are evident and if not corrected, repayment may be at a risk

## **Excessive Risk**

Relationship where impairment of one or more credit components has occurred and loss of principle or interest is likely

## **Unacceptable Risk**

Relationship where a loss of principal or interest is assured

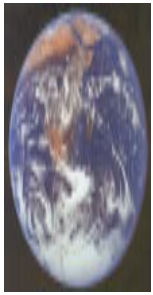


# Quarterly Review of Classifications

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## The review:

- Ensures the review encompasses a review of debt service
- Makes it difficult to overlook this tangible measurement tool



# Credit Deterioration

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If significant credit deterioration occurs between quarterly reviews:

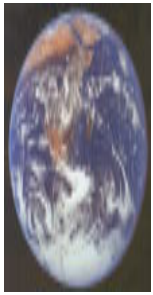
- Adjust classification
- Begin remedial action

Creditworthiness declines can occur at anytime. For example:

- Regulatory changes
- Natural disasters

Prompt update of classification is critical to controlling potential losses. It:

- Draws attention to a worsening situation
- Prompts corrective action



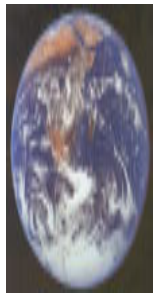
# Remedial Action for High Risk or Worse

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Place on a watchlist or other similar internal list of potential problems and begin corrective actions when companies are classified “high risk.”

- The credit officer sets specific strategies and action plans to fix the weakness.
- Senior management is advised through circulation of the watchlist.

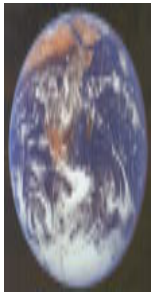
Transfer to the problem loan department, if it exists, companies downgraded to “excessive risk” or “unacceptable risk.”



# Examples of Warning Signs and Data Gathering

FOUNDATION	WARNING SIGNS	DATA REQUIRED
Industry Dynamics	<ul style="list-style-type: none"><li>• Laws Change</li><li>• Increase in competition</li></ul>	<ul style="list-style-type: none"><li>• Legislative notices</li><li>• Price levels, list of new competitors</li></ul>
Financial Condition	<ul style="list-style-type: none"><li>• Unable to meet interest payment</li><li>• Poor account fluctuation</li></ul>	<ul style="list-style-type: none"><li>• Payment status, debt service ratio</li><li>• Account fluctuation from branch</li></ul>
Management Quality	<ul style="list-style-type: none"><li>• Significant staff turnover</li><li>• Turnover of key executive/owners</li></ul>	<ul style="list-style-type: none"><li>• Staff levels/new hiring</li><li>• Executive rosters</li></ul>
Security Realization	<ul style="list-style-type: none"><li>• Decline in executability</li><li>• Decline in control</li></ul>	<ul style="list-style-type: none"><li>• Time required to execute security</li><li>• Inventory and A/R levels</li></ul>

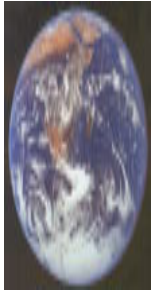




# Problem Loan Administration

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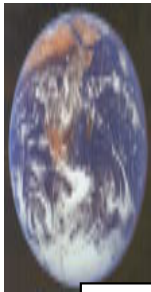
- Definition
- Working With
- Predicting
- Recovery Strategy
- Cash Flow/ Breakeven
- Stages of Deterioration
- Causes for Workouts



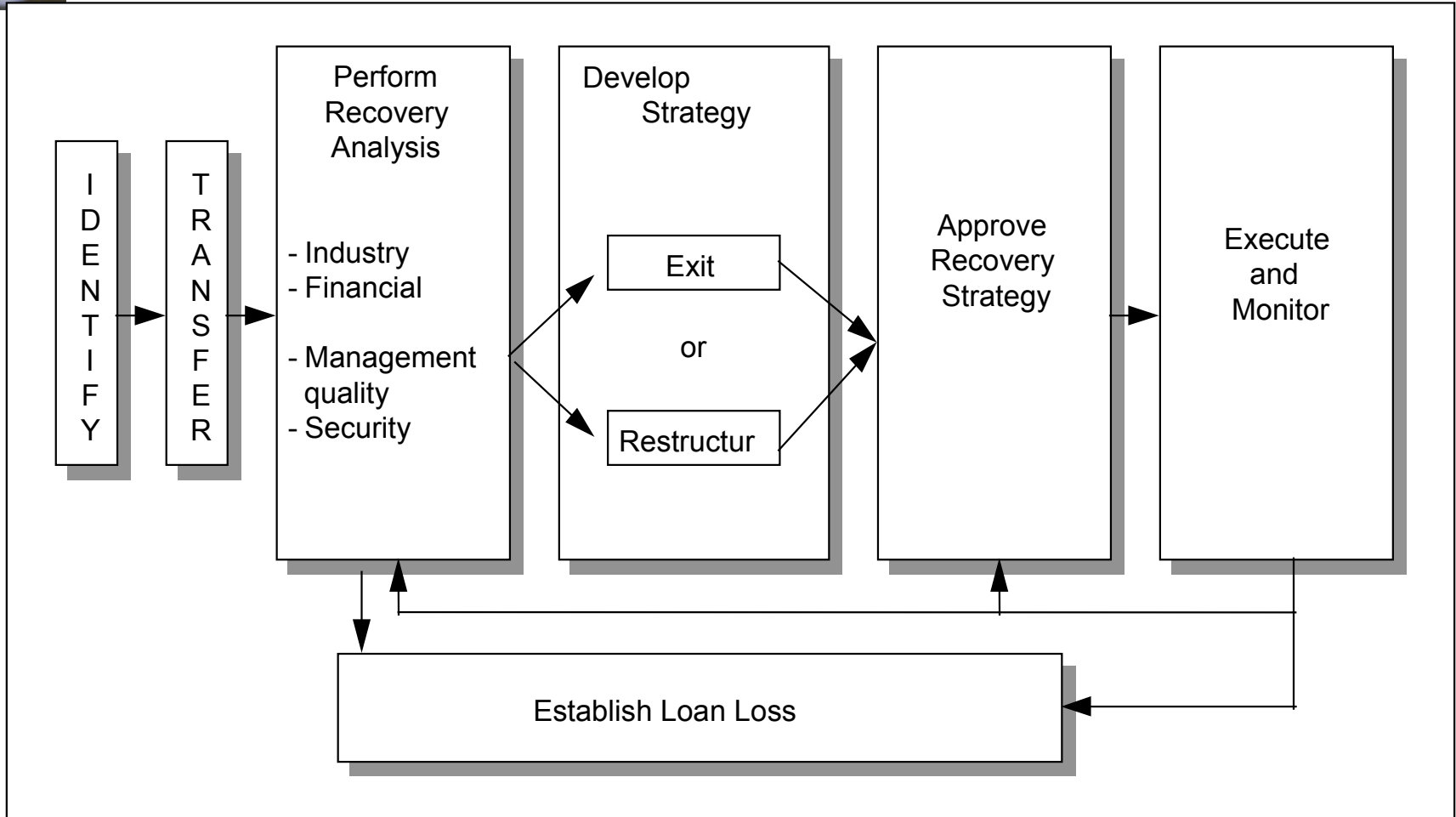
# Avoiding Problem Loans

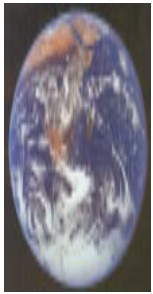
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- Good underwriting
- Active monitoring
- Early problem loan identification
- Aggressive corrective action



# LOAN WORKOUT



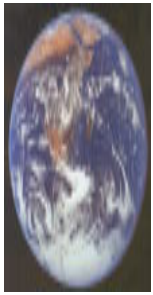


## LOAN WORKOUT

### **THE WORKOUT PROCESS SHOULD GUIDE THE BANK IN “WORKING-OUT” PROBLEM LOANS IDENTIFIED IN THE MONITORING PROCESS**

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- Problem customers should be identified via the risk classification system introduced in monitoring
- The problem customers should be analyzed, based on the analytical framework introduced in the analysis process
- Then, strategies and action plans should be formed to solve the problems
- The strategy will ultimately result in a decision to restructure or exit
- The restructure or exit decision drives the actions
- Based on approval, these plans should be implemented
- Progress should be monitored monthly and problems re-analyzed and new action plans developed as necessary

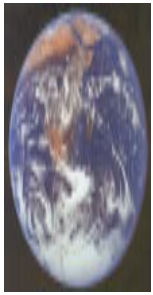


## Major Causes of Business Failure

(according to business owners)

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- Incompetent Management
- Lack of Managerial or Technical Experience
- Neglect
- Lack of Performance-Oriented Goals
- Failure to consider Capital Requirements
- Product/Service Life Cycle Impact
- Disaster
- Regulatory Environment
- “Leveraging” Equity

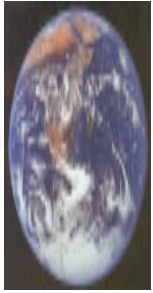


## **Primary Causes of Loan Losses**

(in order of occurrence)

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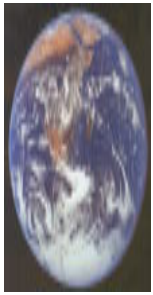
1. Poor Initial Selection of Risk
2. Timidity
3. Overlending
4. Documentation Flaws
5. Failure to Implement Approval Terms and Conditions



## Management/Operational Early Warning Signs

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1. Lack of Supportable Business Plan and Forecast
2. Consistent Failure to Meet Projections
3. Use of Short-Term Solutions
4. Capital withdrawals/Dividend Payouts
5. Poor financial Controls
6. Poorly coordinated Interoffice/Intracompany Transactions
7. Changes in the Personal Habits of Owners/managers
8. Supporting Multiple Family Members at the Expense of Expertise and/or Profitability
9. Venturing into New Business or Investment Areas
10. Managing Profitability

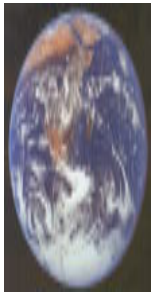


# Critical Occurrences

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- Requests for Credit Restructures
- Collateral Overadvances
- Overdrafts
- Conversion of Trade Debt to Notes Payable
- Tax Problems
- Rapid Growth in Plant or Equipment
- Mismatched Asset Funding
- Debt Servicing Deficiencies





# Calculating a Debt Service Deficiency

## Needs

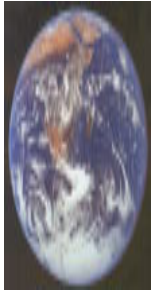
- Existing Operational (Bank) Debt
- Accounts Payable
- Accruals
- Term Debt Payments
- Overdrafts or Held Checks
- Asset Acquisition Needs

LESS

## Sources

- Margined Accounts Receivable Borrowing Base
- Margined inventory Borrowing Base
- Equity Capital
- Extended Trade Creditor Terms
- Asset Sales

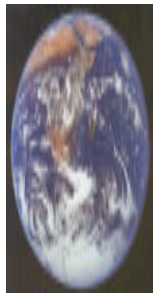
= **Debt Service Deficiency\***



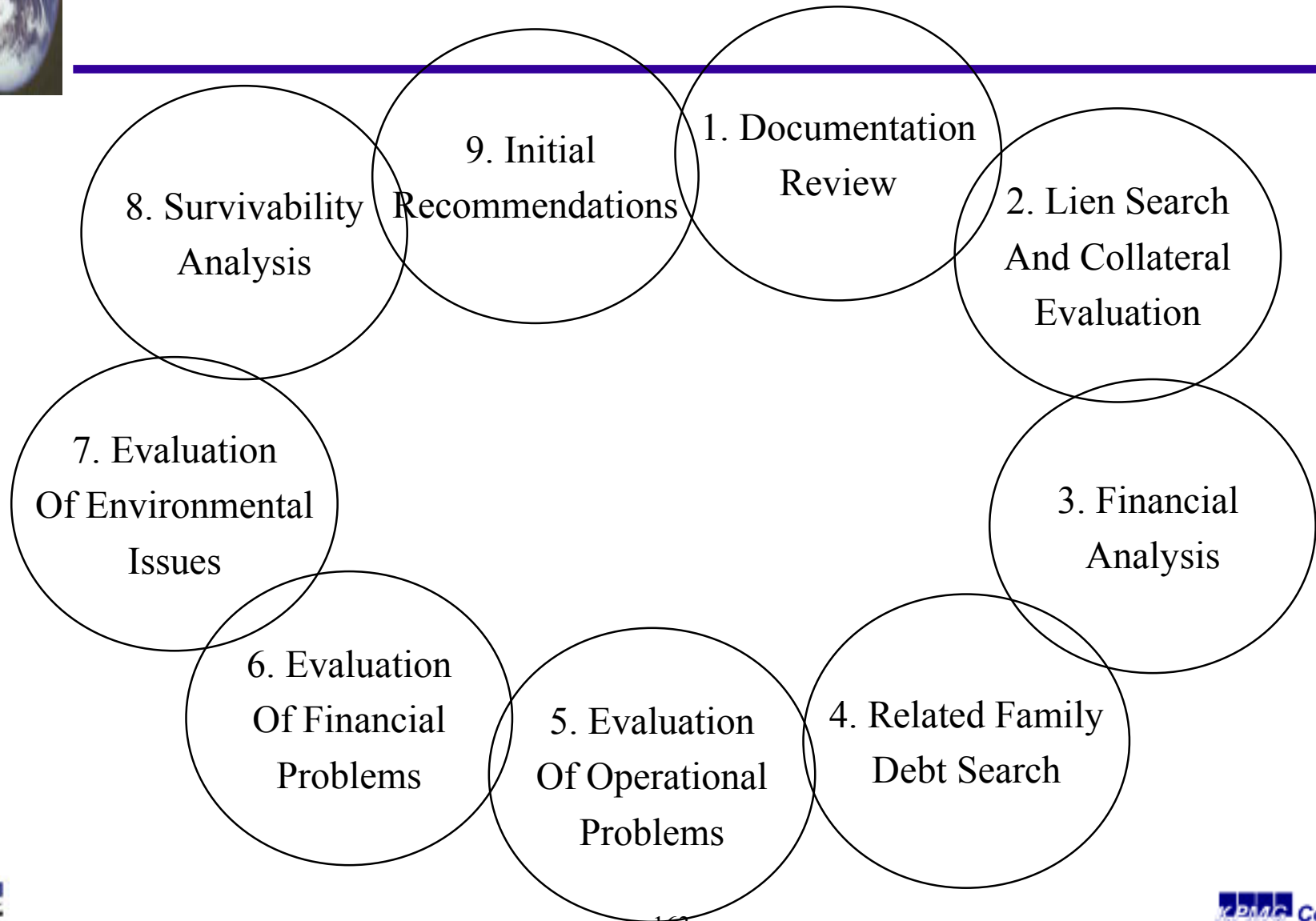
## Working with the Problem Credit

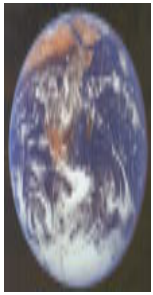
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- Sounding the Alarm
- Determining Who Will Handle the Problem Account
- Analyzing the Problem Loan: A Nine-Part Process
- Analytical Aids
- Special Considerations



## Analyzing Problem Loans: A Nine-Part Process



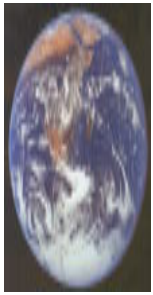


# Analyzing the Problem Loan

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## **Part 1: A Complete Documentation Review**

- Authority Documents
- Notes
- Security Agreement and Financing Statement
- Mortgages/Trust Deeds
- Assignments
- Entity Verification
- Guarantees
- Loan Agreement

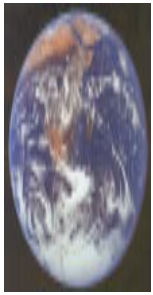


# Analyzing the Problem Loan

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## **Part 2: Complete New Lien Search and Collateral Evaluation**

- Certified Lien Search
- Determination of Lien Priorities
- DMV Search
- Status of Taxes
- Status of Suits and/or Judgments
- Analysis and Valuation of Collateral

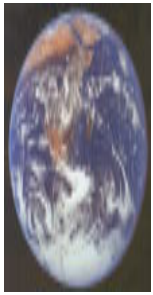


# Analyzing the Problem Loan

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## **Part 3: Financial Analysis**

- Accrual Basis Financial Statements and Projections
- LIFO versus FIFO Inventory Valuation Analysis
- Pro Forma Cash Budget and Profit Plan
- Tax Returns
- Updated Personal Financial Statement
- Depreciation Schedule

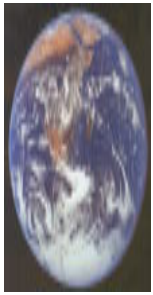


# Analyzing the Problem Loan

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## **Part 4: Related Family Debt search**

- Related Entity Debt
- Related Guarantor Debt



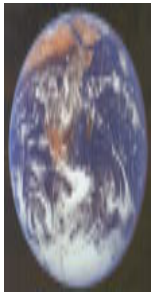
# Analyzing the Problem Loan

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**Part 5: Evaluation of Operational Problems**

**Part 6: Evaluation of Financial Problems**



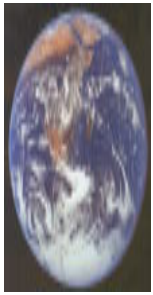


# Analyzing the Problem Loan

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## **Part 7: Evaluation of Environmental Issues**

- Environmental (EPA/DEQ) Impact
- Markets (Geographic Cost-Benefit Analysis)
- Products/Services (Mix and margin Analysis)
- Distribution Systems
- Competition

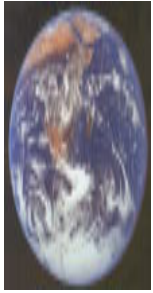


# Analyzing the Problem Loan

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## **Part 8: Survivability Analysis**

- Can the Borrower Survive?
- What Resources Are Necessary?
- Where Will the Money Come From?
- How Much Risk Capital Is the Bank Willing to Put In?



# Analyzing the Problem Loan

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## **Part 9: Initial Recommendations**

- Decide What You Want to Do
- Decide How to Implement
- Decide a Time Line